SOME WORDS OF CAUTION FOR INVESTORS IN HIGH-TECH SPECULATIVE STOCKS

By James B. Cloonan

A lack of funding prompts some developmental-stage companies to turn to variable convertible preferred stock issues, with a negative impact beyond what many investors would normally expect.

Nothing is free, and those of us who want to invest in very high-potential-return stocks should be aware of the accompanying high risk. In the arena of speculative stocks, probably the most potentially explosive and the most risky is the high-technology (or biotech) small company still in the development stage (no profit, little income). In this stage, the company is judged based on its "burn rate"—its losses due to research and development each period—and the estimated time to profitability.

While these companies usually have low market capitalizations (share price times number of shares outstanding), they are not like the small-cap stocks in our Beginner's or Intermediate Portfolios, or our Shadow Stocks. These stocks are profitable companies with established book values and fairly low price volatility. [The Beginner's Portfolio is an experimental portfolio of small stocks designed to show that a consistent approach can be followed without great time requirements; a complete description appeared most recently in the May 1998 *AAII Journal*. The Intermediate Portfolio is similar in concept, but allows for more qualitative analysis; the most recent discussion of this portfolio appeared in the February 1998 *AAII Journal*. Shadow Stocks are stocks of smaller firms that are out of Wall Street's spotlight; this list was most recently featured in the February 1998 *AAII Journal*].

Developmental-stage technology stocks are not profitable and have high price volatility. The only reason for investing in them is the chance that their product will be successful and that the rewards in that event will provide a return well in excess of 100%. Most individuals investing in these stocks are aware of the obvious risk that the product won't make it in the marketplace.

Many of us may have invested in such stocks with a small percentage of our portfolios, willing to accept the risk/reward ratio as perceived.

In judging such opportunities, however, it is important to look at risks beyond the probability of technical success. These firms often take longer in the development stage than planned and run through the money originally invested. If they are behind schedule or previously have had to go back for financing, the more traditional financing avenues will be closed. Predatory investment operators will be waiting in the wings with offers to buy variable convertible preferred stock.

Convertible preferred stock is a normal method of venture investing with the convertible price predetermined—sometimes below market depending on the condition of the company. The variable convertible bases the conversion price on the lowest stock price up to the conversion date. The justification is protection against a price decline, but the scenario that is established can be disastrous for existing stockholders.

Let's see what can happen: Suppose we have a company with eight million shares outstanding and the market price is $8 a share, so its market capitalization is $64 million. The predatory investor provides $10 million of capital via convertible preferred stock. Under the convertible terms, the stock will be convertible at the average closing price during the lowest five-day price period prior to conversion. The company thinks that with the influx of new money, the stock should be strong, but even if it slips to $6 a share, the new investors

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will only get 1.667 million shares (\$10 million ÷ \$6 = 1.667 million shares), which would amount to 17% of the company [the company would have total shares outstanding of 9.667 million (8 million + 1.667 million); 1.667 million ÷ 9.667 = 17%].

But suppose convertible investors start to short the stock, pushing the price down [when you short a stock, you sell the shares at a specified price for delivery at a future date, anticipating that the price will be lower when the shares must be delivered]. At \$6 a share, they can short 1.667 million shares, with it being considered a hedge rather than a pure short because they are long the convertible (they own the underlying shares). But shorting that much could easily drive the stock down to \$3 a share. At that price, they can convert into 3.33 million shares, which means they can short an additional 1.667 million shares, driving the price to \$1 where they can establish their conversion price and convert into 10 million shares. They would then use 3.33 million shares to cover their short position, generating a profit of \$15 million (they received an average of \$4.50 a share on 3.33 million shares for the short sales; \$4.50 × 3.33 million = \$15 million).

Thus, after converting their investment of \$10 million, they have a \$5 million profit, plus they own 6.667 million shares, which amounts to 37% of the company's 18 million shares outstanding (8 million + 10 million). At this point, they can hold onto those shares if they choose, or sell the balance slowly as the stock starts to retrace.

It could have been worse. And unless someone can prove intent, it is very difficult to bring a civil suit. So how can this type of activity be stopped?

Well, of course, if companies wouldn't subscribe to such offers, they wouldn't exist, but a desperate company will do most anything to stay in business because they have hope. The predatory investor doesn't care—he can make a profit whether the company stays in business or not.

Legislation is difficult because short sellers serve a market function, and hedging is often justifiable and necessary.

The market itself could reduce the occurrence. If hedge funds and larger investors would buy stock of such companies at the right time, they would reduce the impact and make additional profits. This, however, is a tricky type of investing.

For most individual investors, if you believe in the technology of such companies and have them in your portfolio, keep up-to-date on the company's financing plans. If they are going to, or just have, financed with variable convertibles, sell and wait to pick up the stock again when the price falls.

I have held two such stocks over the past six months. In one case, the stock was driven down so far that the number of shares needed for conversion was beyond the authorized shares of the corporation, and a settlement had to be reached. In the other case, the stock was driven below \$1, but miraculously bounced back to \$2.50 after the conversion period.

Contributing to the severity of the situation is Nasdaq's new requirement that stocks trade above \$1 per share or be delisted. When a stock goes below \$1, it becomes more difficult to short, thereby limiting the extent of the "death spiral." If the corporation has to do a reverse split, it becomes shortable again and drives the price lower. While Nasdaq has reasons for the \$1 price, I do not believe that this is a good rule on balance.

Another factor making it easier for predators to drive a stock lower is the margin restrictions. When a stock is driven below \$5, buyers can no longer buy on margin, and when it goes below \$3, previous margin must be repaid. Both of these factors make driving the stock down much easier—not that anyone should be margining such stocks, but it happens.

Nasdaq has rules aimed at requiring stockholder approval in some of these cases, so read your proxies carefully.

The lesson from all of this is that a lack of funding in development-stage companies can have a negative impact beyond what would normally be expected.

Investors who buy such stocks should watch out—or watch for special opportunities. ◆