DISCOVERY EQUITY PARTNERS

Market Update

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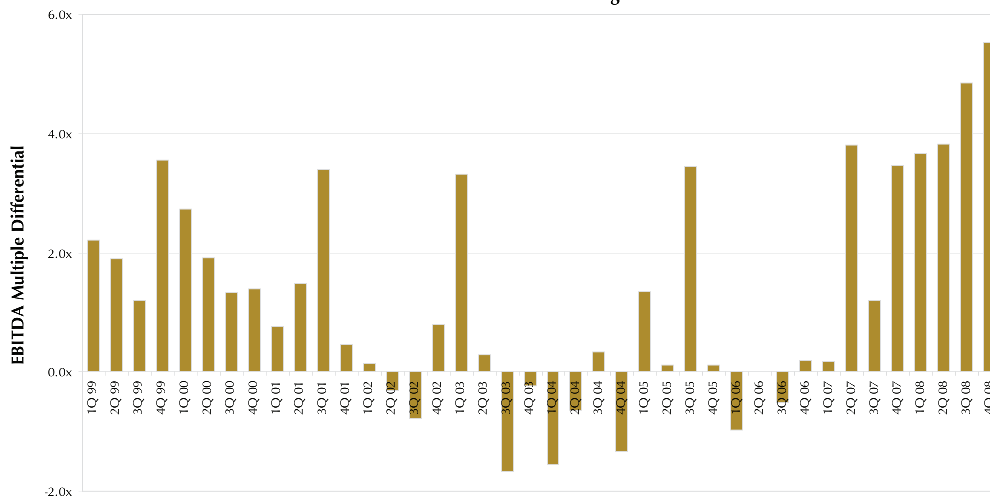
Micro-Caps Ripe for Takeover Arbitrage

In recent issues of our Market Update we examined the precedent conditions for micro-cap takeovers. We began with an investigation of the extraordinary pressures behind the steep decline in micro-cap stocks. We found that micro-caps have been battered worse than larger cap public equities due to four factors; 1) their inherent illiquidity, 2) indiscriminate dumping by hedge funds, 3) a flight to safety in larger cap names by traditional value investors, and 4) scant new capital allocated to micro-caps. The result is a marketplace that lacks the apparatus to efficiently price micro-cap stocks.

In contrast, the M&A market for micro-cap firms was shown still to be fully-active, offering the opportunity for efficient valuation of micro-caps on an enterprise basis in change-of-control transactions. For the past ten years, even through the economic downturns of 2001 and 2008, there have been at least 20 acquisitions per quarter of micro-cap public companies. This activity level is driven in large part by the desire of larger cap firms to find new avenues to growth, which can be fulfilled by the acquisition of micro-caps that have thriving business niches. Meanwhile, micro-cap Boards are more interested than ever in finding value-maximizing alternatives to public ownership.

So, the question to be answered now is, "How profitable can the confluence of these conditions be for a portfolio focused on micro-cap takeover targets?" We accumulated a significant amount of valuation data that is summarized in the chart below. For each quarter over the past ten years, we measured the difference between public market multiples of micro-cap stocks and the M&A multiples of public micro-caps that were acquired during those same time periods. The most striking observation is that the spread of takeover valuations over trading valuations for micro-caps grew dramatically during 2007 and 2008 to reach its widest point in the fourth quarter of 2008.

Micro-cap Arbitrage Opportunity
Takeover Valuations vs. Trading Valuations



Source: Capital IQ database and Discovery Group research

The principal driver of the widening differential between these two markets is the collapse of public valuations. Still, the stability of M&A valuations is noteworthy. It is especially interesting that, according to Standard and Poor's, while the prices paid by LBO firms has fallen, the takeover multiple paid by strategic acquirers for micro-cap companies actually increased during 2008.

The implications for micro-cap investors are clear. There is a significant arbitrage opportunity between the two alternative markets for micro-caps. As of the fourth quarter, the median price paid for shares in a public micro-cap was 5.2X EBITDA while the median valuation in a micro-cap takeover was 10.7X EBITDA. Stated another way, the average micro-cap company that is acquired at an average takeover valuation can provide shareholders with "more than a double." We found that even during times of relative parity, such as from 2002-2007, an M&A-oriented, actively-managed portfolio focused on the best targets (not the average ones) outperforms passive micro-cap strategies by a wide margin, with a distinguished alpha component. The pronounced pricing anomaly of this market augurs particularly well for an event-driven approach to micro-cap investing at this time.

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Discovery Equity Partners, L.P. seeks to exploit the valuation anomaly associated with small capitalization public companies that trade at deep discounts to their economic value as a result of limited research coverage, low trading liquidity and rare institutional sponsorship. The Fund accumulates meaningful ownership stakes in anticipation of an accretion in value that will result from specific company and industry developments. Discovery Equity Partners, L.P. is managed by Discovery Group I, LLC. Return data is preliminary and subject to audit.

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