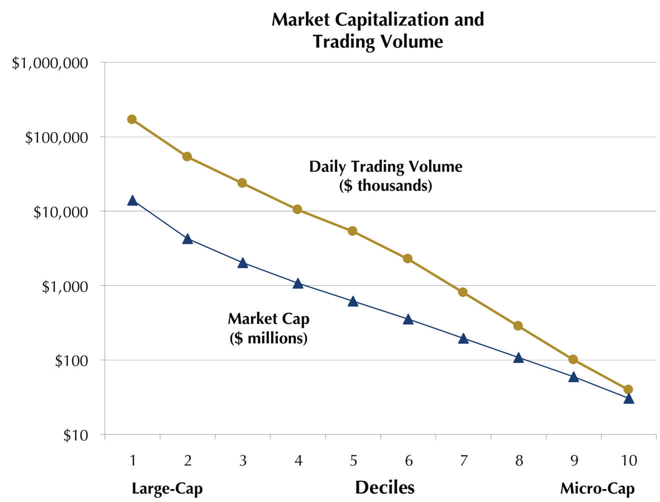
DISCOVERY EQUITY PARTNERS

Market Update

JUNE 16, 2009

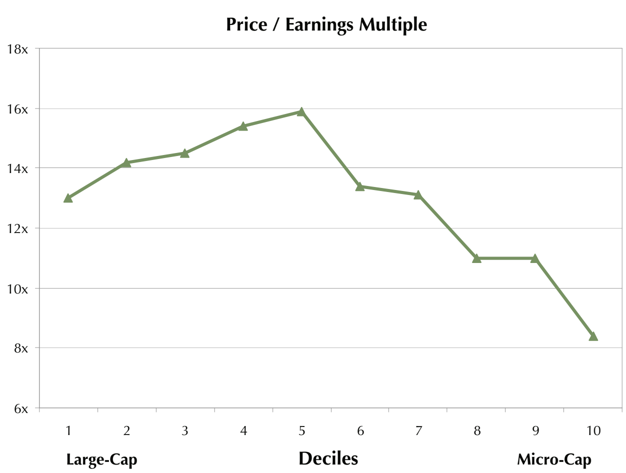
Micro-Caps: Illiquid and Undervalued

The equity market has experienced extreme volatility over the last year. As we have noted in past analysis, micro-cap stocks have been no exception. In fact, the sell-off in the smallest of stocks was more severe than mid-size or large stocks in late 2008. In early 2009 selected sectors of the equity markets rebounded. Given that many of the micro-cap indices have recovered from extremely low levels, we recently studied some data to take a fresh look at micro-cap dynamics and relative valuations.



The overall state of the micro-cap universe has not changed for several years. In fact, U.S. equity capital is even more concentrated in large cap stocks, causing micro-cap stocks to be abandoned by research analysts, brokerage houses, and investors. One of the most telling ways to highlight this phenomenon is to rank all companies in the US equity market by size, break the data into deciles, and study the characteristics of each decile. The graph above shows two important facts. First, moving down the rank from large to small companies results in a dramatic drop in market cap. Note how the blue market cap line shows a rapid decline ***on a logarithmic scale***. Secondly, the same decline in size rank results in an even more dramatic decline in the dollar value of shares traded per day for each stock. As market cap shrinks, trading liquidity evaporates causing an inefficient market for micro-cap stocks.

The impact of infrequent trading of micro-cap stocks is a lower valuation. Effectively, the smaller the capitalization, the greater the illiquidity discount. Micro-cap stock prices and valuations are penalized not because of industry, strategy, management, growth, or profitability - but simply because their shares are rarely traded. Evidence is shown in the graph below, plotting recent price-to-earnings multiples for each decile of the US equity market.



Our analysis shows that this undervaluation relative to large-caps is persistent, regardless of market environment. This relationship existed in the late 1990s, during the slow-down of the early 2000s, and throughout the recent bull and bear markets. Furthermore, our experience has shown that the only way for a micro-cap company to close this valuation gap is to pursue a change-of-control transaction. As shown in our April Market Update, strategic acquirors are paying handsome premiums for micro-cap companies, erasing the micro-cap discount and delivering fair value to micro-cap shareholders.

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