What Directors of Small-Caps Need to Know: A Conversation with Third Creek Advisors' Adam J. Epstein

By **Dan Lonkevich**
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Adam J. Epstein, the founding principal of **Third Creek Advisors** in Danville, Calif**.**, is the author of "The Perfect Corporate Board: A Handbook for Mastering the Unique Challenges of Small-Cap Companies," which was published by McGraw-Hill in 2012.

Epstein was named as a National Association of Corporate Directors Board Leadership Fellow in December, the highest level of credentialing for corporate directors and corporate governance professionals.

He currently serves as the lead independent director on the board of **OCZ Technology Group (OCZ)**, a San Jose, Calif.-based developer of solid-state drive technology for computing devices and systems. He also advises a number of boards of small-cap and micro-cap companies, as well as investment funds.

Epstein was a co-founder of **Enable Capital Management**, a San Francisco-based fund manager that has been an active investor in small cap equity financings since 2003. He no longer manages money for any hedge funds.

Enable, which is currently run by Epstein's co-founder Mitch Levine, has invested at least $474.4 million in 316 PIPEs since 2003.

The DealFlow Report recently spoke with Epstein about governance at small cap companies.

In your book, you argue that corporate governance for small-cap companies is different than for larger companies. Give us some examples to show how the challenges are different.

Almost 80% of public companies in the U.S. have market capitalizations below $500 million. Forty percent of senior exchange-listed companies have market capitalizations below $250 million.

The vast majority of these small public companies aren't sufficiently cash-flow positive to support their growth initiatives internally, so they require regular access to the equity capital markets. To be clear, these financings are not elective surgery. They are mandatory.

Ample trading volume is a key prerequisite for constructive financing. For boards of these companies, trading volume is actually a material enterprise risk. Large public companies needn't ever concern themselves with trading volume, and certainly not as an enterprise risk.

An inordinate number of small public companies don't have in-house counsel. For thinly capitalized small public companies, this means that directors actually have to be apprised of how/which law firms are retained, and how even small litigations are proceeding, since higher-than-expected legal expenses can have material impact on balance sheets. This is something that large company directors never have to worry about, inasmuch as they often have double-digit sized in-house legal departments.

Large public company boards often spend seven-digit amounts annually for large consulting firms to help them assess various risks, compensation strategies, operational efficiencies, compliance and so on. Most small public company boards have no resources for this at all, so all the work needs to be undertaken by them and the company.

There are some Fortune 100 boards that spend more money on one director, than small public companies spend on their entire boards.

What are the most common and biggest corporate governance misconceptions small-cap company chief executive officers and directors face?

The biggest misconception far and away in my opinion is that somehow having a "ticker symbol" entitles a company to growth capital that is sufficient to fund a company's near- and long-term objectives. Nothing could be further from the truth, yet this "entitlement ethos" is pervasive.

To the contrary, access to equity capital markets, in particular, is *earned* by companies that chronically under promise and over deliver, have sound capital market/corporate finance strategies, and are well-governed.

You definitely need to have directors who understand the small-cap equity financing market. The biggest problem is often the lack of capital markets experience on a board.

If you had a grocery store or a sandwich shop and the key risk is getting bread delivered every day and you have nobody who knows how to do that, you get an idea of the problem. Even an elementary school kid would ask: don't you need somebody who knows how to get the bread?

Growth capital experience is critical and most companies don't have enough of it on their boards. It's a large problem and I've seen it every day.

What is the best way to select a board of directors for a small cap company?

Selecting a board of directors for a small public company is no different than selecting a board for any sized public company. It's just that small public companies have far less resources to accomplish the same tasks.

Boards need to be reflections of a company's principal opportunities, risks, and customers. Since most small public companies can't afford to use professional search firms, most of the directors are found through word-of-mouth and referrals.

What are the qualifications of a good director for a small-cap company? How are they different than the qualifications of good director of a larger company?

Directors of small public companies don't make very much money, and, given the thin capitalizations and ubiquitous risks which face small public companies, they often work long hours and need to be available on very short notice.

In other words, small public companies can disappear alarmingly fast, so they require constant contact and supervision. Accordingly, the most important qualification is passion for the business and its shareholders.

A big misconception about small public company directors is that they "show up four times a year" for a quarterly meeting, and then spend the rest of the time playing golf. I've participated in investing in more than 500 small-cap financings, and have governed and advised lots of others. I've yet to come across those directors.

Do hedge fund managers make good directors of small-cap companies? If so, why? What about attorneys?

The short answer is that for any given small public company, the directors who are best suited to govern are those who, in addition to having sufficient expertise to discharge audit, nominating, and compensation committee responsibilities, are uniquely suited to address the company's principal opportunities, risks, and customer viewpoints.

To the extent that a hedge fund manager or attorney has those attributes, and is passionate about a company and its shareholders, then he or she could make a good director. That being said, no, there is nothing in particular about hedge fund managers or attorneys that make them "good directors" in my experience.

What does a director of a small-cap company need to know to be a good director?

To be a good director of a small public company you need to, first and foremost, be passionate about the company and its shareholders, because, again, you are going to be working an awful lot, on very short notice, for not a lot of money.

Second, you need to be relentless in thinking about threats to and opportunities for the business, and never stop asking relevant questions of officers and fellow directors.

Third, you need to immerse yourself in the company's industry, and with the CEO's approval spend time with lots of non-C suite employees to better understand the company's strengths and weaknesses.

Last, you need to attend corporate governance continuing education programs regularly to stay apprised of important governance trends, best practices, and relevant legislation.

How has the Jumpstart Our Business Startups Act affected corporate governance issues? Please give examples.

I think it remains to be seen how impactful the JOBS Act will be on small public companies. I'm of the belief though, that for pre-initial public offering companies the ability to be able to file Form S-1 registration statements confidentially is incredibly helpful, considering that 40% to 50% of would-be IPOs don't happen every year.

Before the JOBS Act, they'd file their S-1s and all their competitors could see everything about their customers, margins and the secret sauce. They were really damaged by the disclosures. I'm a big believer that confidential filings will be impactful and lead to more IPOs.