Trading Volume: The Unsung Enterprise Risk of Small-Cap Companies

By Adam J. Epstein

If location, location and location are the three things that matter most to retail stores, then volume, volume and volume are the three things that matter most to many small-cap stocks.

Why Trading Volume Matters

Not only are the vast majority of U.S. public companies small—70 percent have market capitalizations of less than $500 million—the vast majority of them periodically require infusions of outside capital to fuel growth or survive downturns. In the absence of predictable cash flows and material fixed assets to lend upon, the source of those funds is often the equity capital markets.

The more trading volume a small-cap stock has, the easier it is to undertake equity financings and the cheaper the cost of that capital—for a relatively simple reason. The faster and easier it is for investors to sell a position, the less concerned they are about disastrous downside scenarios, and the more easily they can opportunistically take advantage of price appreciation. Put a different way, if investors can't get out in good times or bad times, they're either not going to get in to begin with or they are going to a charge a premium to offset the risk of illiquidity.

The more trading volume a small-cap stock has, the easier it is for investors to accumulate meaningful positions in the open market. And investors who accumulate meaningful positions are more likely to buy stocks that are actively traded because the prices don't skyrocket and plummet when comparatively small amounts of stock are bought and sold. For example, if an investor is trying to buy $10,000 of a stock and this purchase pushes the price up by 15 percent, the investor is simply going to choose another stock.

The more trading volume a small-cap stock has, the more likely it is to attract equity research analysts, who, in turn, can assist with marketing the stock to institutional investors. In other words, if a stock doesn't trade in sufficient volume for an equity research analyst's clients to buy it, then the equity research analyst isn't going to make any money covering the stock. Simply put: No trading volume, no equity research.

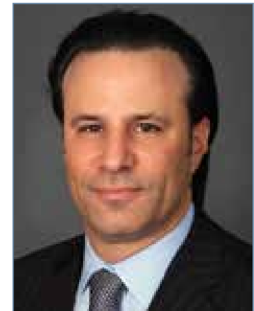
The more trading volume a small-cap stock has, the more likely it can use that stock as a currency to buy other companies. For example, why would another company accept an all-stock acquisition offer if the stock doesn't trade in sufficient volume for the acquisition consideration to ever be monetized?

The more trading volume a small-cap stock has, the more value employee-retention tools (e.g., stock options) have. For example, employees are not going to stay at the company because of in-the-money stock options if the company's stock doesn't trade in sufficient volume to enable employees to exercise the options and sell the stock.

In essence, trading volume in small-cap stocks is tantamount to *alternatives*. Every small-cap market veteran has at least one favorite example of companies pursuing a half-dozen or more disparate products, services or business models before finding success, and the common characteristic among them is often trading volume. Trading volume facilitates access to the equity capital markets, and cash provides business options. Hence, a conspicuous lack of trading volume leaves a small-cap company with a dangerously low margin for error.

As important as trading volume is to the success of small-cap companies, it's also as widely misunderstood as it is elusive. Many directors of small-cap companies have a poor understanding of the importance and nuances of trading volume for a couple of reasons:

Capital markets experience.



Adam J. Epstein is lead director of OCZ Technology Group and advises small-cap boards through his firm, Third Creek Advisors LLC. This article is excerpted in part from his book, *The Perfect Corporate Board: A Handbook for Mastering the Unique Challenges of Small-Cap Companies* (McGraw-Hill, 2012). Contact him at ae@thirdcreekadvisors.com.

Many small-cap boards lack directors with material small-cap capital markets experience. Additionally, many small-cap management teams are inexperienced in operating public companies of any size.

Not intuitive. The most sensible way for the uninitiated to view the ebb and flow of capital in the stock market is to understand that companies that are performing well will attract the most shareholder interest. That's true, for example, in the Fortune 500, where a limited number of companies are conspicuously well known and meticulously dissected by hordes of professional and amateur analysts, bloggers and the like. However, that is considerably less true for the thousands of small-cap companies that operate in near obscurity to the extent that even if they were handily outdistancing their peers, hardly anyone might know.

There is, perhaps, no other issue that vexes more small-cap directors than why two companies that appear quite similar could have stocks that trade at appreciably different volumes. At the root of this issue is often a fundamental lack of understanding of how sustainable trading volume is generated. Like constructing anything that is durable and sustainable, generating trading volume is a process based on certain axioms, and there are no short cuts.

Generating Sustainable Volume

Nearly every small-cap director knows that the basis for generating long-biased investor interest is reliable, compelling financial performance that distinguishes a company from its peers. But where many small-cap directors go astray is in their presupposition that financial performance is the basis of generating trading volume, and the only catalyst. Unlike large public companies, in which positively differentiated financial results are immediately parsed, digested and acted upon, resulting from ubiquitous information, many small-cap companies have to first create the audience.

The audience for many small-cap stocks isn't dictated by qualitative measures nearly as much as it is by math. That is, if a stock is too illiquid for institutional investors to buy in the ordinary course of their business without pushing the stock price up appreciably, then the proper audience for the stock isn't institutional investors. Easily one of the most underappreciated facts among small-cap officers and directors is that developing trading volume sufficient enough to facilitate institutional trading is generated first from retail investors. Retail investors (i.e., individual investors and/or nonprofessional investors) typically purchase considerably smaller positions than do institutional investors, and they are also less sensitive to the purchase price. Therefore, it is retail investors who supply all the volume in the capital markets for small-cap companies until such time as the trading volume is material enough to support institutional investors.

The company can have a great business, accurately identify who can realistically buy the company's stock and take effective steps to reach investors, but it still isn't going to see an appreciable uptick in trading volume if the company (and its service providers) can't effectively sell stock. Like a lot of things that get obfuscated and needlessly complicated over time, the process of selling stock to either retail investors or institutions is actually not that complicated. Small-cap companies that have actively traded stocks over extended periods of time have (1) straightforward, understandable company presentations that are geared toward the audience; (2) set and achieve conservative expectations with investors; (3) answer questions succinctly and clearly; (4) have mechanisms for constructively keeping interested investors apprised of the company's progress; and (5) respond to follow-up inquiries in a timely fashion.

Avoid Common Mistakes

As important as it is for small-cap officers and directors to take appropriate steps to generate ample, sustainable trading volume, it's equally important for them to avoid common mistakes, which don't achieve the objective.

Perhaps the most common, and worst, strategy for inactively traded small-cap companies is the "We're just going to keep our heads down, deliver results, and the investors will find us" strategy. Even if the company operates in a sector that is hot and the company's revenues are growing quickly, this is a strategy that will not result in sustainable, ample trading volume. Sectors come in and out of favor, and while revenue growth will always attract attention, the vast majority of small-cap companies can't grow at breakneck speed forever. Therefore, sooner or later, company management is going to have to formulate a strategy to actively and constructively communicate with its target audience on the Street.

Moreover, like a lot of things having to do with corporate finance and capital markets, it's a numbers game. There are literally thousands of small-cap companies, so the "head in the sand" strategy is doomed on that basis alone. A "head in the sand" strategy is also not wise for companies to choose when things aren't going terribly well operationally, unless the company generates sufficient cash flow or it has cash reserves to sustain operations. Opting to cease any engagement with the Street when a company is performing poorly ("going dark") is likely to have two deleterious corporate finance consequences: (1) the company's trading volume will deteriorate to such an extent that the company will be prevented from raising equity capital; and (2) if the company is able to raise equity capital, the terms will be cripplingly dilutive.

There are small-cap management teams that take the opposite approach from the "head in the sand" strategy and often can

end up with similar results. There are management teams that are incessantly on the road speaking to investors. But the law of diminishing returns applies to this situation for two reasons: (1) companies that continuously speak to investors can't possibly always have something new and material to report, so each meeting can be greeted with correspondingly less interest from investors; and (2) investors will begin to question who is running the company while the CEO and CFO are crisscrossing the country every week speaking to investors.

Almost every business day, small-cap companies spend considerable amounts of money and management time meeting with institutional investors who can't (or won't) buy the company's stock. There are many reasons why this happens. It suffices here to say that prior to meeting with any institutional investors, management should consider, at a minimum, answering one question: Does this institution own any stock in substantially similar companies (i.e., industry, market capitalization and trading volume)? If the answer is no, then it's worth questioning whether such a meeting is a good use of time. This exercise applies to companies whether they have lots of institutional investors or none.

Small-cap officers and directors should approach any third parties that agree to increase the company's trading volume with circumspection. Because the goal for small-cap companies should be sustainable trading volume, not incidental or periodic spikes in trading volume, directors should make sure that management's analysis of any such third parties is focused on one critical question: Can this vendor provide verifiable data showing increased, sustained trading volume for substantially similar companies? Though it's hard to know precisely why, most veteran small-cap observers are mystified at how rarely this question is asked, and how rarely the answers are thoroughly verified.

Enterprise Risk

No matter how it's sliced, trading volume is critical to myriad small-cap companies. And for many small-cap companies it's a material enterprise risk. Directors should focus on it and make sure, together with management, that there is a thoughtful, realistic strategy to achieve both near-term and longer-term liquidity objectives. Considering how seminal it is to so many elements of small-cap life, trading volume should actually be a metric that is regularly discussed and evaluated in the boardroom alongside other more familiar aspects of corporate performance. D

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