Communicating With the Street: Addressing Small-Cap Challenges

Edited by Adam J. Epstein

Due to a confluence of resource constraints, capital-markets inexperience, economic headwinds and a rapidly evolving investor landscape, many small-cap companies struggle to effectively communicate with the Street. And, unlike at most larger public companies, poor Street communication can create material enterprise risks for small-cap companies that are characteristically reliant upon recurring access to the capital markets for growth capital.

To better understand these challenges and offer some guidance to small-cap directors, *NACD Directorship* held a roundtable discussion with a small-cap investment banker, David J. Enzer, managing director, Roth Capital Partners; a small-cap institutional investor, Timothy J. Keating, CEO, Keating Capital; and a small-cap investor relations professional, John W. Heilshorn, co-founding partner, Lippert/Heilshorn & Associates.

Why do so many small-cap companies underperform when interacting with the Street? Is it more attributable to naiveté or recalcitrance?

Enzer: Healthy combinations of both. Many smaller public companies have management and directors who have had limited or no prior experience as public company stewards, and management teams and boards also tend to be smaller in size. Since the internal support network for management is correspondingly thinner than in larger companies, the cadence, timing and content of communications with the Street can be erratic. Street engagement can be daunting and a "trial by fire" process to the uninitiated, and many management teams simply avoid the Street to focus on their day jobs.

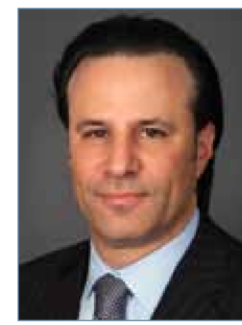
Heilshorn: Small-cap issuers need to better appreciate and more effectively counter the prevailing point of view among investors: that many small-cap companies are undercapitalized, unable to withstand operating shocks to their business models, staffed by management and board members who have little experience with the unique challenges of thriving in the small-cap ecosystem, and are seemingly unwilling or unable to expand their business models to achieve ongoing growth and profitability.

Keating: Mostly naiveté. Since the passage of Regulation FD (Fair Disclosure) over a decade ago, many management teams have been confused by its intent. Contrary to conventional thinking, the intent of Regulation FD is not to limit the flow of information. Instead, the purpose of the law is to level the playing field by ensuring that all parties—and not just the privileged few analysts—receive the same information at the same time.

What are the most prevalent mistakes small-cap companies make in communicating with the Street?

Enzer: A failure to communicate clearly with an appreciation for the audience. For example, small-cap technology companies often use highly technical terms and specifications instead of plain English. A mix of small, growth-oriented institutional investors and retail investors typically owns shares of smaller public companies, and many lack technical educations and backgrounds. Accordingly, communications with the Street will resonate with only a small portion of investors unless that technology-speak is simplified and more emphasis is given to what most small-cap investors care about—growth and financial performance.

Heilshorn: A systemic failure to treat investor relations as a strategic imperative for the company. Unlike larger public companies that operate in the "mainstream," where access to capital and institutional support are ubiquitous, small-cap officers and directors are typically embattled with making certain that the company's



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enterprise value properly reflects its business performance. Electing not to put the proper investor relations policies and procedures in place to offer management the opportunity to present a cogent business plan, with proper forward guidance to targeted investors and analysts, will all but guarantee life in the "boundary waters" of Wall Street for small-cap companies.

Keating: I routinely see several communications mistakes in the small-cap realm that, taken together, destroy management's credibility and make investors run for the hills and on to the next opportunity: One, a failure to communicate on a consistent, scheduled and timely basis, regardless of whether the news is good or bad. Two, a failure to translate non-GAAP metrics into GAAP metrics, e.g., no one except management knows what "orders" or "bookings" means in terms of revenue. And three, chronically overpromising and underdelivering.

Given the austere enterprise risks associated with illiquidity, what should small-cap directors understand about building and sustaining trading volume in their company's stock?

Enzer: Smaller companies need to develop a comprehensive plan for getting on and staying on the radars of investors to drive liquidity. In fairness, there are a few realities today that work against liquidity in small-cap stocks: fewer retail brokerages can encourage clients to buy low-priced, smaller public company stocks; there are fewer brokerages today that focus on the capital markets and corporate finance needs of small-cap companies; and many institutional investors have gone "upstream" to buy shares of larger, less risky, more liquid companies. CEOs and CFOs need to be proactive. For example, they should learn who the respected research analysts are in the company's industry and develop a relationship. Or they should ask existing institutional investors for introductions to other investment funds. Also, having board members with relevant capital-markets experience can greatly enhance the path toward liquidity.

Heilshorn: Sustaining and in some cases creating and/or recreating liquidity for a small-cap stock require a strong communications foundation, with management regularly establishing and achieving financial and nonfinancial milestones to foster momentum in building its business. The No. 1 communications goal and mechanism to assure continued growth in liquidity is performance. Building and sustaining trading volume also requires regular mentions of the company in trade, regional and national press; engaging retail investors through social media platforms; speaking at well-attended investment conferences; focusing attention on existing shareholders and securing their commitment to the company; and a capital-markets agenda that exercises the very purpose of being a public company. "Build it and they will come" is an axiom that doesn't work in today's small-cap market.

Keating: Over the last decade, the economics of secondary sales and trading for Wall Street has been decimated by a combination of compressed commissions (in large part caused by electronic trading) and the decimalization of stock trading. Moreover, once public, the CEO now has two jobs: to manage the company's operations and to manage the public stock. This means more than ever that small-cap companies need to make significant investments of time, money and effort in investor relations, the ultimate goal of which is to create a stock that has visibility, marketability and liquidity. Accordingly, investor relations now has to be viewed as an investment, not an expense.

What do small-cap directors need to know to succeed when speaking with investors?

Enzer: If a board is willing to respond directly to investors, then it should establish a protocol and designate a director who is inclined, capable and experienced with operating in the confines of Regulation FD. Messaging has to be consistent with management's stated goals and what has previously been set forth in press releases, SEC filings and quarterly earnings calls. Furthermore, management and directors must be wary of investors who might engage in such conversations principally for the purpose of detecting and then publicizing inconsistencies.

Heilshorn: Directors should refer all shareholder inquiries to management. It's a flip response to a tricky question, but controlling the company's message to the investment community is best managed by limiting the number of authorized spokespeople. In the best case, there should only be two spokespeople for a company—the CFO and the CEO. When referring an inquiry to management won't suffice, directors should listen passively and say little other than offering to actively convey concerns to management. Quite simply, from a director's perspective, success should be defined by *not* speaking directly with investors.

Keating: First and foremost, all directors need to be operating from a set of written policies and procedures concerning all forms of investor communications. For example, who is authorized to speak on behalf of the company? Is it just the lead director? And what are the topics that may and may not be addressed? The policies should answer these questions. Second, any director authorized to speak on behalf of the company should be required to be on all earnings calls so that they fully understand the types of questions routinely asked by investors and analysts.