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# Every Small-Cap Makes at Least 4 of These 10 Financing Mistakes

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Though you'd never know it from reading The Wall Street Journal or watching CNBC, the industry of providing growth capital to small-cap companies (i.e., publicly-traded companies with market values below $2 billion) is larger in many years than the IPO market. Forgetting for the moment why a $30 billion - $50 billion/year marketplace receives virtually no media attention, these financings take place nearly every business day – there is no such thing as the window being open or closed for "must have" capital. Unfortunately, most of these financings are wildly more dilutive than need be.

Having co-managed a leading special situation hedge fund for many years that invested in hundreds of these small-cap financings, and having also been on the other side of the table inside many small-cap boardrooms as a director and advisor, I've witnessed a debilitating disconnect that (perhaps unsurprisingly) receives no national attention.

On the one hand, there are thousands of small-cap officers and directors, who collectively believe that they do an excellent job accessing and navigating the equity capital markets.

Then there are the special situation hedge funds that provide the billions of dollars of growth capital. They benefit materially, in part, because small-cap officers and directors often aren't the capital markets experts they think they are.

Last, there are retail shareholders and long-biased institutional investors, who are daily victims of the unnecessary dilution.

A few quick observations regarding these three constituencies: (i) the lion's share of small-cap officers and directors I've interacted with are smart, sophisticated, and doing their best to create long-term shareholder value—many just lack material experience shepherding public companies; (ii) in fairness to the special situation hedge funds, they don't create most of the financing challenges brought to them every day, most really want to see these companies succeed, and they're entitled to make a profit like anyone else; and (iii) if you don't want to regularly wake up and find out that you own 20% less of a company than you did the prior evening, you shouldn't be investing in small-cap companies that aren't cash flow positive.

The good news here is that almost all of the serial corporate finance mistakes are avoidable.

The bad news is that every small public company I've interacted with has made at least four of the following 10 critical corporate finance mistakes. Scores of companies regularly make all 10.

The worse news is that in my experience companies are performing more poorly in this regard with the passage of time, not better.

Perhaps discussing these issues frankly in the light of day will help advance better practices.

1. <u>Ignorance is bliss crippling to shareholders.</u> Large-cap officers, directors, and investors assume that CEOs are Street savvy, and understand the equity capital markets. That's a reasonable assumption in the large-cap world. It couldn't be further from the truth in the small-cap landscape, but the assumption is commonplace nevertheless.

   Small-cap CEOs embrace this assumption and feel compelled to project that they "have it all under control" lest they be viewed as something less than a fulsome leader. You can certainly fake some things in life, but you either really understand capital markets and corporate finance or you don't.

   Memo to small-cap CEOs: be brutally frank with yourself and your colleagues about your Street experience, because though you might be able to fool your colleagues and service providers, you're never going to remotely fool the buy-side. When CEOs don't know what they don't know, shareholders lose 100% of the time.

2. <u>Market timing and piecemealing.</u> Most small-cap companies don't raise capital from positions of strength. They don't generate sufficient cash flow to finance their growth objectives so most small-cap financings are "must have" situations not "nice to have." You needn't be a sophisticated investor to examine a company's SEC filings, subtract the recent average quarterly cash usage from cash on hand, and know approximately when that company will likely run out of money. There is nowhere to hide (note to CEOs: you're not alone if you don't recall your IPO-happy service providers warning you about this austere aspect of being a small public company when your company was private).

As companies get closer and closer to running out of capital, their stock price will fall to reflect the impending dilution and the possibility that capital won't be raised, and financing alternatives will commensurately dwindle with the passage of time.

Memo to small-cap officers and directors: (i) if Warren Buffett can't accurately time the market, neither can you, so always raise "must have" capital sooner as opposed to later (i.e., later is always bad); and (ii) virtually no small-cap shareholder has ever been rewarded when companies that really need $10 million decide to raise $5 million now and wait for a better time to raise the other $5 million (i.e., piecemealing is flawed, because the "better time" rarely arrives, and investors know it).

3. <u>Corporate governance Part I: misplaced deference.</u> The principal function of a board of directors is to oversee the implementation of corporate strategy on behalf of shareholders.

Accessing the equity capital markets is a strategic imperative for the lion's share of the 76% of publicly traded companies in the United States that have market capitalizations below $500 million. Many of these companies can't afford to hire seasoned CEOs and CFOs, so it's common for small-cap management teams to lack appreciable experience operating public companies.

When boards are overly deferential to CEOs and CFOs who, intelligence and sophistication notwithstanding, lack material capital markets and corporate finance experience, financings will invariably be unnecessarily dilutive.

Memo to small-cap board members: be careful with what you learn at predominantly large-cap focused corporate governance continuing education programs. Corporate governance "experts" will tell you that management's presentation of the company to investors, for example, isn't a material enterprise risk, and thus requires no board oversight. That might well be the case at Apple, but for a nascent biotech company that requires capital to survive and is run by a rookie CEO, board deference in advance of and during a capital raise can be fatal.

Risk, it turns out, is relative; corporate governance "experts" should know better.

4. <u>Corporate governance Part II: critical skills MIA.</u> Serial need for growth capital notwithstanding, the overwhelming majority of small-cap boards actually lack directors with material, relevant capital markets and corporate finance experience. More specifically, when I was a fund manager, my colleagues and I estimated that well less than 10 percent of the companies seeking financing from our fund had such board members. When a small-cap company, run by comparatively inexperienced management and overseen by a board without capital markets experience, raises capital, there is virtually no chance that company will undertake less dilutive financings than its peers.

This value-destroying chasm is easily bridged. There are hundreds of qualified board members desirous of small-cap board appointments listed on BoardProspects.com, and in the database managed by the National Association of Corporate Directors (and they are all well aware of the diminutive governance resources at small-cap companies).

Why doesn't this situation improve with time? Three reasons: (i) there are far too many small-cap officers and directors who aren't shareholders, and don't feel the full force of senseless dilution; (ii) most small-cap officers and directors don't monitor peer financings and accordingly have no idea how their financings compare to those closed by similarly situated companies (see 5, below); and (iii) the status quo is extremely profitable to seminal capital markets participants (i.e., special situation hedge funds and investment banks).

5. <u>Flying blind – no data.</u> Though every company likes to believe they are unique in the marketplace, the data conclusively show that the likely amount of capital a given company can raise, and the likely financing terms, are strikingly similar to what other similarly situated companies have recently garnered. Data notwithstanding, companies routinely decide in a vacuum how much capital they "need" and the terms they think are "fair," and then hire an investment bank/finder/agent (usually the one who agrees with and promises the same) to facilitate the financing.

Deal data vendors such as PrivateRaise, PlacementTracker, Dealogic, and CapitalIQ, et al. are easy to use, comparatively inexpensive compared to how much waste their use can mitigate, and provide data which depict all the relevant information on historical peer company financings. Instructively, nearly every constituent in the capital markets utilizes historical deal data, except issuers (arguably the party that stands to benefit the most).

It's impossible to overstate how much time, energy and money are wasted by small-cap companies planning for a financing that is just not going to happen remotely as envisioned. The majority of that waste is avoidable by analyzing historical deal data.

  

6. <u>Wrong IB Part I: quantitative vs. qualitative.</u> Choosing the right investment bank should be based upon a quantitative analysis. Unfortunately, it rarely is. An investment bank that has helped a small-cap company with prior financings could be a great choice. It could also be a terrible choice.

   Historical deal data paints a clear picture of what types of financings investment banks are actually doing (as opposed to their marketing materials), and with what kinds of results. For example, an investment bank that has spent the last 24 months almost exclusively doing $20 million to $30 million registered direct and confidentially marketed public offerings might not be the best choice to help a company with a $5 million convertible note financing (and vice versa). Moreover, a bit of data analysis will depict that some banks have discernible track records of undertaking more dilutive financings than their peers. All things being equal, why would your company select them?

   Memo to small-cap officers and directors: when looking for someone to install a new clutch in your Audi, presumably you look for a repair shop that frequently puts new clutches in the same kind of Audi you have with the best results and for the best price (as opposed to simply choosing the largest repair shop in town, your prior mechanic when you owned a Lexus, or the cheapest mechanic you find on Yelp). Choose investment banks the same way.

7. <u>Wrong IB Part II: analyst's clients can't/won't buy your stock.</u> Officers and directors of pre-IPO and small-cap companies rarely understand the business case for sell-side equity research, and consequently they frequently make the same value-eroding mistake. That is, they are smitten with any large or "bulge-bracket" bank that shows interest in them to the exclusion of smaller investment banks that will likely provide infinitely more value.

   Here are the capital markets truisms that large investment banks don't want pre-IPO and small-cap companies to ever figure out:

   - When bulge-bracket analysts "cover" small public companies, they are often "taking one for the team" (sorry Mr. Spitzer, nothing has ever changed in this regard); and
   - Though the analysts will dutifully "cover" your stock, the institutional sales people (who actually use the research to "sell" your stock to the bank's clients) won't make any money from selling your stock after the financing – so they won't even try.

   Memo to small-cap officers and directors: (i) there is nothing wrong with choosing a bulge bracket bank for your IPO or follow-on offering, but be brutally realistic about the help they will actually provide and make sure to also include smaller banks who can do what the larger banks won't; (ii) talk is cheap – if the analyst you're considering predominantly covers companies with market capitalizations many times larger than your company, then they likely don't have any clients who care about your stock; and (iii) beware of board members that strongly advocate on behalf of certain investment banks in the absence of any compelling business reasons (an epidemic on Sand Hill Road).

8. <u>Wrong lawyers.</u> A small-cap company's outside counsel could be an apt choice to represent shareholders' interests in a financing. They could also be a destructive choice (irrespective of the size/reputation of the firm). More specifically, special situation hedge funds have lawyers that have done hundreds (if not thousands) of small-cap financings. If your company's outside counsel doesn't have recent, highly relevant experience (i.e., representing companies like yours, in substantially similar financings in the last six to 12 months) then you have the wrong lawyers to represent the company in the financing. In plain vanilla common stock financings (registered or unregistered), having an inexperienced attorney is unlikely to be impactful on shareholders. But if the company is doing any type of convertible or structured financing, existing shareholders are going to suffer mightily with the wrong lawyers.

   Lest anyone underestimate the importance of this issue, rest assured that special situation hedge funds benefit dramatically from consistently out-lawyering small-cap companies. To make matters worse, if your company doesn't have in-house counsel, then you're also likely overpaying quite a bit for the advice.

9. <u>No idea what the company just agreed to.</u> Depending upon the ebullience of the overall market or the strength of a given issuer, structured or convertible financings are a fact of life in the small-cap world. The documentation for these financings can literally be 6 inches thick, and the definitive deal terms can be extremely complex. Many of the affirmative and negative covenants in these financings are enforced by monetary penalties that can collectively be severe enough to lay waste to frail balance sheets.

   Ask any small-cap special situation fund manager and they will tell you that companies constantly breach these covenants, and it couldn't be clearer from the ensuing "work-out" conversations that the officers, directors, auditors, lawyers, and transfer agents didn't thoroughly understand the financing at issue.

  

Memo to small-cap officers and directors: (i) don't depend on institutional investors to look the other way or waive the penalties (it's a profit center for them); and (ii) make sure that before your company agrees to any financing that the officers and directors understand how all facets of the financing work in plain English.

10. Clinging to fictional valuations. Far too many small-cap officers and directors make critical capital markets decisions based on their day-to-day stock prices.

IBM's stock, for example, trades hundreds of millions of dollars per day; that is, when its stock is $122, it's actually worth $122 a share. Isn't the stock of a $150 million market cap biotech company actually worth $2.50 when that's what Yahoo Finance says? Maybe. But not if trying to sell $25,000 worth of stock drops the stock to $1.68.

Very often, stock prices for small-cap companies are more advisory than indicative. That is, if you can't buy or sell material amounts of stock at the quoted price, then it's not a price in the same way that IBM's is.

Why does this matter? It matters a lot. I can't tell you how many times I've seen small public companies treat their stock valuations like IBM's, turn down "must have" growth capital because of a recently buoyant (read: fictional) stock price, and then subsequently undertake catastrophic dilution.

The three most dangerous words peddled by the industry that encourages private companies to go public are: access to capital. Why? There is no such thing. Ticker symbols—once and for all—don't confer access to capital. If they did, there wouldn't be thousands of capital-starved public companies languishing in purgatory, and desperately wishing they were private again.

Access to capital is earned through chronically underpromising and overdelivering, from constructively and factually communicating compelling growth stories, and timely reporting accurate financial results. There are no short cuts.

There are many small-cap officers and directors who are seasoned capital markets experts. To the many more who aren't, take note: many investment banks and special situation hedge funds would love for you to stay that way. Unfortunately, every day the status quo remains the same, America is losing the high quality jobs and boundless innovation supplied by the small-cap ecosystem. **X**

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