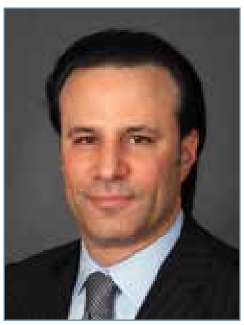
Small-Cap Boards: Follow the Numbers

By Adam J. Epstein



Adam J. Epstein was an institutional investor who now advises pre-IPO and small-cap boards through his firm, Third Creek Advisors LLC. He is the author of *The Perfect Corporate Board: A Handbook for Mastering the Unique Challenges of Small-Cap Companies* (McGraw-Hill, 2012).

Few in the small-cap ecosystem will remember 2015 fondly. Two statistics in particular underscore the unique challenges small-cap companies will face this year and beyond.

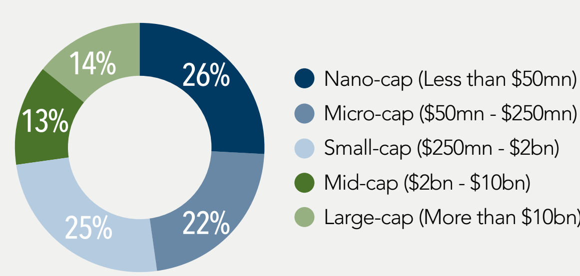
Seventy-three percent. According to Activist Insight, 73 percent of shareholder activist campaigns in the United States in 2015 were waged against small-cap companies. This is an eye-opening statistic by any measure, but it's particularly instructive for those who govern smaller public companies.

In fairness, there is a reason why the preponderance of shareholder activism takes place in the small-cap landscape, and it arguably has less to do with governance than with math. Most hedge funds don't manage billions of dollars. It's far cheaper for an activist to acquire a material position in a $100 million company than in a $100 billion company. Hence the reason why, according to Activist Insight, 48 percent of activist campaigns last year were waged against companies with market capitalizations below $250 million.

That said, when more than 7 out of every 10 activist overtures are brought against small-cap companies (and approximately 70 percent of those overtures are successful, according to Activist Insight), it's evident that small-cap corporate governance is deficient from a buy-side perspective.

Actionable items for small-cap directors in 2016: Take demonstrable steps to optimize governance and communicate those changes clearly to investors. Make sure you understand and address the concerns of your largest investors in particular, since they are the ones who typically invite activists to the "party" when they are dissatisfied. And remember that governance scrutiny is often inversely proportional to corporate performance.

Activist Targets by Market-Cap



Source: *Activist Investing: An Annual Review of Trends in Shareholder Activism*, Activist Insight, 2015

$28 billion. According to Sagient Research Systems, small-cap companies raised approximately $28 billion in the equity capital markets in 2015. If that number sounds big, it is. In fact, it almost eclipsed the $30 billion raised in the IPO market in 2015, according to Renaissance Capital.

It's easy to forget in an economy focused on large-cap companies that the overwhelming majority of public companies in the United States are small. Many small-cap companies access the equity capital markets regularly, because they often don't generate sufficient cash flow internally to fund growth. Put differently, most small-cap financings aren't "nice to have," they are "must have."

Almost any small-cap institutional investor will tell you that most small-cap boards lack directors with relevant capital markets and corporate finance experience. Coupled with the fact that many small-cap companies can't afford to hire CEOs and CFOs with appreciable experience operating public companies, small-cap shareholders suffer from needlessly dilutive financings.

The number one strategic imperative for thousands of small-cap companies each year is raising external growth capital. Unfortunately, the other constant for many small-cap companies is that boards continue to try to oversee a seminal risk they often don't sufficiently understand.

One thing is for certain: trying to raise $28 billion of growth capital in the absence of appropriately skilled boardroom oversight is only going to add to the 73 percent figure discussed above—and then some.