The Constraints of Thin-Cap Company Boards

The role of the board is different for small-cap companies, where the line separating governance from management issues isn't so bright.

By Adam J. Epstein

Whether it's director independence at News Corp., management changes at Yahoo and Hewlett-Packard, or cash balances at Microsoft and Apple, corporate governance in the Fortune 500 is front, right and center for media, regulators, investors and directors alike.

But with all the focus on governance at America's largest corporations, it's easy to overlook an underappreciated capital markets truism: seven out of every 10 public companies in the U.S. actually have market capitalizations of less than $500 million. In other words, not only are the majority of public companies small, but the vast majority of directors govern small public companies. And, just as operating a $250 million company is conspicuously dissimilar to operating a $250 billion company, governing the former is a different undertaking from governing the latter—a lot different.

Small-cap companies are, in a sense, immune-suppressed versions of their larger counterparts. That is, a failed clinical trial, adverse jury verdict or product recall might be little more than routine impediments for a Dow member, but to a $150 million company with a tenuous balance sheet and a stock that isn't sufficiently liquid to facilitate a lifeline of further growth capital, any of those challenges could prove insurmountable.

Just as the large cash holdings of some blue-chip companies can provide, among other things, strategic alternatives and financial flexibility, the opposite is also true. Directors of companies with smaller cash reserves—let's call them thin cap (a trait frequently associated with small cap)—typically operate in environments where alternatives and flexibility are replaced by a cognizance that even seemingly innocuous decision making can have business-ending consequences. Load razor-thin risk management margins on the shoulders of leanly staffed, resource-constrained boards, and it becomes clear why experienced small-cap directors routinely refer to their craft as entrepreneurial governance.

At its core, entrepreneurial governance is the art and science of shepherding an asset in the form of an operating corporation against long odds for risk-embracing shareholders. In so doing, small-cap directors are often required to analyze myriad issues that would never even see the light of day in a Fortune 500 boardroom. Instructively, one only has to attend a few small-cap board meetings to realize that, contrary to the "axioms" often taught in graduate schools, the bright line that separates governance issues from management issues for many larger companies isn't actually a bright line at all in many smaller ones. That is, risks and the consequences that ensue are relative; an issue requiring no board oversight at one company could well require extensive board action at another.

Imagine, for example, you are one of seven directors on the board of ABCD, a $250 million Nasdaq-listed technology company that has been sued by a Fortune 500 company for patent infringement. Though the intellectual property at issue isn't central to ABCD's present or future business, the time and cost of a protracted litigation could have austere consequences.

Moreover, and as is quite common in small-cap companies, ABCD doesn't have any in-house counsel or legal department, and its officers lack

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material litigation experience. At the lion's share of large public companies, the basic elements of defending non-core patent litigation (i.e., hiring counsel, negotiating fees, litigation strategy, etc.) would hardly garner active board oversight for two reasons: 1) most large public companies have extensive in-house legal departments with the requisite resources and expertise; and 2) there is minimal, if any, enterprise risk posed by this type of litigation. Indeed, according to experts in the patent field, it is standard operating procedure at many mature companies. ABCD's directors, however, govern in a dramatically disparate setting, where management's lack of litigation expertise, and the potentially ruinous enterprise risks, compels active oversight.

Resources, or Lack Thereof

To add to the challenge that small-cap directors face in governing in heightened enterprise risk ecosystems, the resources available to undertake the same are often a fraction of what large public company boards have at their disposal. Consider that 1) the total director compensation for a single director at a Fortune 100 company might eclipse the total director compensation for an entire small-cap board; 2) many small-cap companies have half as many directors as large public companies (i.e., five rather than 10); and 3) unlike the annual six- or seven-digit expenditures that can be paid to consultants and board advisors at large public companies, many small-cap boards have no such resources.

As a result of these resource constraints, the composition of small-cap boards is also quite different from that of large public companies. Large public company boards may have up to a dozen directors, and may include former politicians, industry regulators or military leaders, as well as capital markets, corporate finance, legal and governance experts. While many large-cap boards are currently basing their composition on the strategic needs of their companies, it is not common for them to include leaders in their own industries, due to antitrust constraints. Conversely, most small-cap boards are less than half that size and are principally comprised of directors possessing mission-critical expertise; that is, directors who can help with what matters most to nascent businesses—revenue generation, supply

Critical Questions in Advance of a Financing

There are a couple of things that many small-cap companies can count on in 2012: they are going to require growth capital, and they are going to be negotiating with hedge funds for that capital. Unlike their larger counterparts, which predominantly undertake public offerings of equity and debt, small-cap companies raise the majority of their growth capital through privately negotiated deals with hedge funds—typically $20 billion to $30 billion a year, according to PrivateRaise.com.

"When it comes to growth capital, small-cap companies typically need it yesterday, and hopefully on the least dilutive terms possible," says Neil Koehler, president and chief executive officer of Pacific Ethanol Inc. "But negotiating with hedge funds can be a minefield, especially for small-cap boards that often lack the same corporate finance and capital-markets expertise institutional investors have."

Small-cap directors can go a long way toward leveling this playing field by asking the following four questions, and listening carefully to the answers.

Do we have the right investment bankers?

Before negotiating with hedge funds for growth capital, you've got to find them—and finding the right ones for your company is easier said than done. One of the most underappreciated complexities involved in financing small-cap companies is that, for example, the very same 20 institutional investors that finance a $300 million medical device company might well have zero interest in providing growth capital to another $200 million medical device company that otherwise appears very similar to the former. As is so often the case with small-cap companies, high-level similarities notwithstanding, one company's stock might trade $5 million per day and be followed by 10 equity research analysts, while the other company's stock might only trade $500,000 per day and have no equity research coverage. In other words, from an institutional investor's standpoint, these companies couldn't be more different, and investment bankers that ably assisted the former might not even know where to start with the latter.

Consequently, in order to be more exacting in this regard, small-cap directors need to ask whether prospective bankers have completed the same type of financing the company intends to transact for a substantially similar company (e.g., industry, exchange, market capitalization, trading volume and institutional sponsorship) in the last six to 12 months. It's not how many financings the bankers have done; rather, what's most instructive chain optimization, clinical trial design, etc. To be sure, many small-cap boards would benefit dramatically from political, regulatory, capital markets, corporate finance, legal and governance acumen. But large boards aren't practical for small, nimble companies, and they are far too costly. Accordingly, small-cap directors must simply do more, with considerably less.

Variable Experience

In addition to ubiquitous enterprise risk and constrained resources, small-cap directors often govern companies where management teams have considerably less experience operating public companies than what you'd characteristically find in larger public companies. That is, intelligence, sophistication, talent and success notwithstanding, there are literally thousands of either first-time or comparatively inexperienced public company CEOs and CFOs operating small-cap companies.

Moreover, the quality and expertise of professional service providers focused upon small-cap companies are highly variable. And while large public companies collectively tend to select from a comparatively limited pool of blue-chip banking, auditing and law firms, there are hundreds of small-cap professional service providers.

Accordingly, just as ABCD's directors were compelled to actively participate in rudimentary elements of its patent litigation, the majority of small-cap directors must eschew the level of deference routinely afforded highly experienced management teams and service providers at larger public companies in favor of a considerably more hands-on approach.

Addressing the Challenges

Small, fast-growing public companies play an irreplaceable role in the U.S. economy—they are seminal catalysts for driving innovation and employing Americans. Even in the best of times small-cap directors face appreciable challenges. But, given the added regulatory burdens and global economic austerity of late, impediments to small-cap success are growing at a time when our economy can ill afford underperformance and failures. D

is how recently they've successfully completed a similar financing for a company just like yours.

Do we have the right deal lawyers?

One thing you can count on is that the hedge funds interested in financing your company have highly capable, specialized counsel assisting them. Especially since so many small-cap companies operate without in-house counsel, the need for similarly skilled deal lawyers can't be overemphasized. Accordingly, and just like with selecting the right investment bankers, directors should ask whether the actual attorney working on their financing has counseled at least a handful of substantially similar companies in the last six to 12 months in connection with the same type of financing your company intends to transact. Lawyers either have extensive, recent, highly relevant small-cap corporate finance experience, or they don't. Unfortunately, and far too often, deal lawyers are selected due to an existing relationship as opposed to whether they possess the requisite experience—sometimes with ruinous consequences.

Are the prospective investors a good fit for our company?

Part of the "minefield" referenced by Koehler is that, marketing hyperbole notwithstanding, not all hedge funds have the best interests of your shareholders at heart. Accordingly, prior to accepting financing terms from a lead investor, the board should ensure that at least a handful of companies previously financed by the prospective lead investor are contacted to discuss their experiences. It's hard to know what's more surprising in this regard—how rarely this is done, or how predictive the feedback will be.

Are the proposed deal terms the least dilutive our company can attract?

Multiple times each week small-cap directors are presented with financing terms by an investment bank and told that the terms are the best available in the marketplace. Though not always taken, the board's best next step is to trust but verify. "It never ceases to amaze me how few boards actually verify that the financing terms being presented are the least dilutive available," observes Steven Dresner, president of DealFlow Media Inc. "Directors can purchase access to any one of a number of databases that track deal terms, and can study the financing terms transacted by every company like yours, including in many cases the hedge funds that invested."