



November 24, 2020

Don't Forget the Little Guys

Question: What do the 4 companies listed below have in common?

<u>Companies:</u>	<u>Market Cap</u>	<u>YTD Return</u>
SPS Commerce	\$3.48B	77.6%
Simulations Plus	\$1.08B	86.2%
Brooks Automation	\$4.99B	65.6%
Agilysys	\$0.943B	57.4%

Answers:

- A. Small - Market Caps < \$5 Billion
- B. Probably unknown by most retail investors
- C. Returns for 2020 >50%
- D. Growing earnings at high double-digit rates
- E. Growth not limited by law of large numbers
- F. Attractive acquisition candidates by bigger companies - at Premiums

Acquisition Premium:

Investors categorize stocks by their Industry, Sector, Country and their Size, or Market Cap.

While the Mega Cap stocks such as Amazon, Google, Facebook, etc., attract most of the news and investor attention, Small Cap stocks offer the advantage of a greater probability of enhanced returns, often by being acquired by a larger company.

Larger companies use their access to capital markets as currency to buy smaller companies operating in niche spaces that offer synergies. This enhances their earnings, sales, market penetration or technology.

Acquisitions at a zero "financial" cost occurs when an acquirer's price/earnings or sales earnings exceeds those of the company they are buying. For example, Company A that trades at a 30 P/E buys a smaller company trading at a 20 P/E is said to be "accretive" to earnings by paying 20 to get 30.

Thus, identifying smaller companies that are attractive candidates for bigger companies offers portfolio managers a dimension for generating excess returns generally not available to mega cap investors such as Amazon.

Example:

Two weeks ago, Home Depot (HD) announced it is acquiring HD Supply Holdings (HDS), (**an SLG Micro Cap Portfolio Holding**) for \$56 per share; this is a 35% premium over its two-week prior trading price of \$41.64.

HD previously owned HDS and sold the company to private equity in 2007, and it was then taken public in 2013.

The buyout price values HDS at an 18 times price-to-cash flow multiple, while HD currently trades at 17.7 times. Given the similar P/CF's, the financial cost will be nominal to zero and is designed to be strategic for HD.

Longer Runways

Bigger companies eventually run up against the law of large numbers.

For example, can Amazon:

- a. Exponentially increase its \$380 Billion (2020 est.) annual sales?
- b. Double in size from its current \$1.56 Trillion market cap?
- c. Continue to grow earnings to justify its 91 times Price/Earnings ratio?

And while Amazon may indeed be able to continue its astounding pattern of growth, we believe that Simulation Plus has a better likelihood of doubling in size over the next 3-5 years from its current \$1.2 Billion market cap.

Smaller companies often face different challenges, including: customer concentration, higher borrowing costs, limitations for attracting executive talent, etc.

However, on the other hand, they are less constrained by legacy bureaucracies and sunk costs, and thus are able to more rapidly adapt and get new and innovative products to market.

And although the early Covid-19 market has substantially favored the Mega-Cap Tech companies serving the stay-at-home market, smaller companies have begun to outperform over the past several weeks, as summarized in the chart below.

This is being driven by positive Covid-19 vaccine news and the view by investors that larger technology companies are fully valued.

Total Return: 23 Mar '20 - 23 Nov '20



Comparable Returns

	Price Change (%)		Total Return (%)		NAV Total Return (%)	
	Cum	Ann (CGR)	Cum	Ann (CGR)	Cum	Ann (CGR)
iShares Russell 2000 ETF	81.00	142.04	83.01	146.05	82.94	145.91
SPDR S&P 500 ETF Trust	60.33	102.04	61.69	104.60	61.68	104.57

Sincerely - Brad Stanley, CFA

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