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Mary Lisanti's favorite small-cap stocks

Jennifer Schonberger | Jul 23, 2008 10:21am EDT | Comment

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A 28-year veteran of small-cap growth research and investing, Mary Lisanti is president and chief investment officer of AH Lisanti Capital Growth, where she manages the firm's small-cap growth strategy. Lisanti has spent 12 years as a small-cap analyst and strategist on Wall Street, holding such positions as CIO of ING Investments, senior portfolio manager for the small-cap growth and mid-cap growth strategies at Strong Capital Management and managing director and head of the small/mid-cap team at Bankers Trust Company. Lisanti was named Fund Manager of the Year in 1996 by Barron's.

What qualities do you look for in a small-cap stock? Have your criterion changed given the current macro environment?



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"We are growth investors. Therefore what matters to us most is the ability of the company to grow its earnings at an above average rate for a period of time. We do a lot of research, such as interview management, talk to customers, look at research reports and 10Ks and 10Qs, among other things. The majority of companies in which we invest tend to have a product or service we believe is unique and different; they tend to have management teams that we think highly of, and they have strong balance sheets — no debt and several dollars per share in cash.

"My criterion has not changed. The only difference is we probably spend even more now with management. The quality of management really makes the difference. It's huge. In the 80s, you would score them in your research reports. People have gotten out of that habit because everything's been easy and now, now I think it's going to come back into vogue."

What are your three favorite small-cap stocks with market caps of under \$1 billion for the year and why?

"**Buffalo Wild Wings** (Nasdaq:[BWLD](#)) is one of my favorites. It goes back to the idea that even the consumer environment is difficult, if you offer people something of value, you can do quite well.

"You have to buy the argument that people are still going to go to out to eat. If you buy that argument, Buffalo Wild Wings is a company that is growing about 25% to 30%. It's a sports bar. It sells a lot of chicken wings and beer, but also sells other things. It's very much like Applebee's used to be years ago when they were your neighborhood place. Their average ticket is \$11 and that's what I like about them.

"The company has this combination of table service and order yourself. You can do anything from, 'I want to be in and out quick,' to, 'I want to sit here, have a beer and watch the ballgame.' They will attract everyone from the working lunch crowd, to the after lunch crowd, which [consists of] the teenagers, soccer moms, after-work crowd, dinner crowd and late-night crowd.

"As a result, [the restaurants] have to have good managers because they can be open the entire time. Now, because they're open the entire time and they attract so many different groups, one of the things that's hard for them to do is open in new markets.

"There are two key points to this year. One, the company is acquiring a franchisee in Las Vegas that will be additive to earnings, and two, Buffalo Wild Wings is opening new stores in all its existing markets. When it opens in existing markets, it will get a bump. It needs to have enough stores in a market because people will not travel far to go to Buffalo Wild Wings. It is not a destination. It's your neighborhood place. It also has a deal with ESPN where it advertises on [the network]. The company [has purchased] big screen plasma TVs that it's putting into all of its restaurants.

"People are focused on chicken wing prices. Everybody says margins are going to come down, but nobody understands that the company has a lot of flexibility in the menu and could lock into the wing prices. Buffalo Wild Wings chooses not to, but if prices go up, it could lock them in. The other thing is that the company is the only one without negative comps. Clearly, the value proposition is working.

"Buffalo Wild Wings right now sells at \$1.35/\$1.40. Next year it's expected to earn \$1.65 to \$1.70 — so about 24% growth. The stock is about \$32 and if this is going to be a 25% grower through the recession, this stock will probably go to \$45.

"Historically, what's so interesting about this company is if you're able to get through a downturn and to grow through, you get a multiple above your growth range. That's what happened to Tiffany's in the early '90s. That's what happened to Starbucks. If Buffalo Wild Wings can continue to execute as well as it's been executing, I think they could grow right through this and get a higher multiple.

“**Cavium Networks** (Nasdaq:[CAVM](#)) provides semiconductors that enable intelligent networking. The semiconductors basically take you beyond the routers; it's a system on a chip for networking, communications and security applications. They're used in router switches, gateways, networking systems cards. The semiconductors solve the issue of 'I have all this different branded stuff in here, and I need to upgrade to put in new applications — how do I do this?' These are intelligent processing products so they have enough software in them that they can bring you completely up to date in terms of what you need to be able to do. They give you better security protocols and secure connectivity.

“The company's customers include Cisco and Aruba. You usually have to upgrade because of the security threats and the complexity of networks, and if you upgrade your equipment, you're going to upgrade it with these guys.

“The stock is at \$24 and the company is growing like a bandit. Earnings this year are forecast to be \$0.45, up from \$0.14, so the growth is over 200%. Next year they're forecast to be \$0.75— growth of 70%. I see it surpassing a high of \$34 probably within the next 12 months.

“**Luminex Corp.** (Nasdaq:[LMNX](#)) makes the systems that do genetic analysis to identify new drugs and genes. Its trick is multiplexing technology that allows you to do 10 times more assays than you normally could, however it's still not as automated as it could be all the way down the line. The company plans to automate more on the front end which is where all of the labor is. It's a productivity tool.

“The company is just breaking into the black. it's going to be break-even this year and is going to make about \$0.30 for next year. Medical companies like this put so much money into R&D, so we intend to buy them just as they're becoming profitable. For most other companies, we want them to be profitable.

“It looks expensive on the numbers because it's selling at about \$22 and it's going to earn \$0.33 in '09. Part of the reason why it's selling at \$22 as opposed to in the teens is because of the potential for a buyout. I think the \$0.33 for '09 will become \$0.60, then \$0.80, then something like \$1.20. A year from now you're going to be looking at \$0.65 will basically pay about 50 times for that, which will get you to the mid-\$30s.

“However, what will happen as a result of turning profitable is it's a razor and razor blades business. You're selling assays. If it sells enough assays to turn profitable the growth will take off. It will grow 40% or 50% for years. This is a model that's been proven many times before. Abbott was the first one to do it.

“**Natus Medical Inc.** (Nasdaq:[BABY](#)). It's not a high growth business in its inception. They started a business to develop hearing impairments for babies and neurological dysfunctions. It brought in a manager about four or five years ago who had a history of building companies and turning them into growth companies. Sometimes he sells them and sometimes he lets them grow, but he's turned around a few medical device companies before. When he came in he

began making acquisitions. As a result, the company has broadened what it does. Hearing, which was 100% of the business, is now only 53% of its business. The company has moved into newborn care and neurology and it's pushing aggressively internationally. Natus Medical will probably need to keep making acquisitions as we go forward; historically, it's made about one or two a year.

"This year the company is growing at about 40% and next year will probably grow a little over 20%. The earnings are \$0.65 and \$0.85 for 2008 and 2009, respectively, and the stock is about \$20. But this should be a \$30 to \$40 stock in a year. Again, it's one where we had high confidence in the management team. When [the new manager] joined the company, it was barely profitable and last year they earned \$0.47."

What's your typical investment time horizon when you're investing?

"We don't have a time horizon so much as we have a valuation discipline. We look at P/E-to-growth. Let's say a company can grow 30% a year. If they can grow 30% a year, then we want to pay no more than 30 times next year's earnings for them. Now hopefully, it won't surpass that in a month, because sometimes they do. But if they surpass that in a month, it's usually because they've gone up 40%. I can't tell you when the stocks are going to move, but if we have that kind of a discipline it helps tell us when there's excessive risk in the story."



About the Author

Reporter Jennifer Schonberger is based in SmallCapInvestor.com's Washington, D.C. bureau.