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SMALL CAP ROUNDTABLE

Home > Small Cap Insights > Small Cap Roundtable

July 2008 Roundtable Part 3

Jennifer Schonberger | Jul 25, 2008 09:08am EDT | Comment

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As the credit crisis has enraptured equities valuations have been squashed on stocks good and bad.

Translation: valuations on financially healthy companies are attractive at current levels. However, that's not to say that there isn't earnings risk with higher commodity prices eating away at margins of companies in many sectors and further possible reductions in earnings estimates.

Our panel also explores the perils of inflation, stagflation, the beleaguered greenback and the presidential election's effect on small cap equities. Lastly our experts take a look at possible share dilution and buybacks in an environment that's shown varying degrees of illiquidity. (This is part three of a five part series.)

How are valuations on small caps now across the board?

Lisanti: "They're cheap. When you look at the Russell 2000 growth, it's selling at about one times its growth rate, which is very low. The Russell growth is selling at about 20-times its earnings and is supposed to grow at 19% going forward. Stuff in our portfolio is selling at about half its growth rate. We're basically with companies that are growing about 45% and we're paying about 22-times earnings for them. That's really cheap. They have to overcome these economic headwinds and if they do, then the stocks will go up. But economic headwinds are not monolithic, sometimes they can prove to be positive.

"My guess is they're probably underweight small-cap growth and overweight small-cap value."

Oberweis: "Valuations are still substantially below what we typically see for high-growth equities. To be quantitative, we track the average P/E of companies that are growing in excess of 30% with a market capitalization of less than \$1 billion. There are typically about 600 constituents in that group. It's not a perfect statistical indicator, but it gives us a very good sample of where valuations have been and are going.

"Based on the standard forward estimates, the average P/E within that universe is about 23. Based on historical reported numbers, the average P/E within that universe is 33. To put it into perspective, the average historical over the last, say, five years based on forward is 30 and based on historical is 36. We're well below average. The low we saw at the end of March was 21.7 based on forward. Based on historical, it was 30.5."

O'Halloran: "Valuations do look attractive whether one looks at the S&P 500 or the Dow Jones Industrials, stocks are yielding more than treasuries — the earnings yield on stocks is higher than the 10-year treasury. With treasuries yielding in the vicinity of 4% and a P/E multiple on the Russell — 15 to 17 times earnings, depending upon where the market is — stocks are yielding more in terms of earnings than bonds. I believe that the economy will begin to improve in 2009, so I think that valuations are attractive here."

Wyatt: "Valuations seem fairly cheap. I think anytime we're in a contractionary market, value plays abound because people tend to react in extremes. To elaborate, in a time like this, people just aren't willing to pay even the low end of pricing multiples they were willing to pay prior to the downturn. I view pricing multiples as a gauge of optimism. Today's low multiples tell me that people just aren't all that optimistic about future earnings or the future for that matter."

What is your earnings outlook for the second half of the year? Do you think analysts are too optimistic and estimates have further to fall?



Mary Lisanti is president and chief investment officer of AH Lisanti Capital Growth. 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: "In certain sectors, absolutely, yes. I think there are certain areas where people are far too optimistic and certain areas where they're far too pessimistic. It really reflects what's done well over the past six or seven years. I think they're too optimistic on banks, home builders and REITs. I think people are way too pessimistic on health care. The estimates in health care are probably too low, but that may not resolve itself until we get a new president. I think that people are very nervous about the consumer space and it's not going to be a monolithic. I think people are also very nervous about tech."

"We expect most of the companies that we cover to meet their earnings estimates. Do we expect a lot of beats? No. Is there anybody that expects a lot of beats in this environment? No."

Oberweis: "Not anymore. I think at this point they're probably too pessimistic. Just last quarter we had the opportunity to drop estimates pretty sharply ... [analysts are] dropping numbers for companies that aren't really subject to macro economic fluctuations. Specialized companies that have products or services that aren't really being hampered by the broader macroeconomic concern may see surprises [to the upside]. We're seeing tons of companies that have limited constriction associated with macroeconomic growth, as valuations have come down quite a bit. I think that's a very interesting place to be."

O'Halloran: "There is earnings risk in the market; estimates for the second half of 2008 probably still need to come down. Earnings for 2008 are going to be down from '07 because we've had an economic slowdown. Our portfolio is forecasted to grow earnings at 20%+ this year, so if the rest of the market is experiencing negative growth, our companies can become more valuable."

"There already have been a lot of earnings cuts this year, and there are likely some more to come. In my view, the shock effect of them has already been felt, and the market already knows that they're coming. When they come, the stocks may go up because the market realizes that these earnings estimates have bottomed, and the companies will be growing off these bases. Looking ahead over the next year, the market's is likely going to move ahead of the sell-side analysts by six months or more."

Riley: "Analysts tend to be overly optimistic. In general earnings will be more challenging, and so I think you're going to see a difficult operating environment in the next six to nine months. There's a view that if a company is either losing money or having a difficult time, that automatically means the stock price is going lower. We contend all that is priced in and more."

Evans: "Earnings are going to be under pressure. Let's be clear about that: earnings are highly suspect, they will be challenged. You have to have a great deal of valuation support because the majority of companies right now have earnings revisions that are more likely to be down than up."



Jim Oberweis is president and lead portfolio manager of Oberweis Asset Management, a growth equity investment management firm that manages approximately \$1.5 billion in micro, small, and small/mid capitalization growth strategies globally, primarily for institutional investors and its own proprietary mutual fund family. Mr. Oberweis is also president of The Oberweis Funds.

"I don't know what the exact numbers are going to be, but we are in a stagflation type of environment. We're in an inflationary environment, and with that as a premise, investors will be behooved to find companies that have pricing power. In a lackluster demand environment, those companies that can raise their prices should do pretty well. Materials and energy names and, to a certain degree, health care (which has been a poor performer year-to-date), are possibilities that should do well because they have the ability to raise prices."

Wyatt: "For the most part, I think analysts have done their part to lower expectations, something that was needed as the fundamentals going forward just weren't there. That said, there are still companies with high growth expectations built in. These are the companies to avoid right now because there's a whole slate of macroeconomic factors that could lend a hand in a firm missing, and not nearly as many that would lead to them surprising."

Do you think the impact of higher commodity prices on earnings will really take its toll on corporate earnings in the second half?

Lisanti: "Some companies will be able to absorb it and grow; others won't. If a company has something unique and different that people want, then they'll be just fine. If they don't, it's just another boulder on their head that pounds them into the ground. It's not going to be distributed evenly, unfortunately."

"I would say that the other piece that you have with small caps is there are always a certain amount of companies in the process of turning around. One of the problems that happens as companies try to grow from small to mid-sized to big is they oftentimes outgrow their management and make mistakes. And through those companies we'll do almost completely different economic cycles."

If they're early in their turnaround, it's not going to matter what the economy's doing because they're going to have so many levers to move their margins up that it's not going to matter."

"The way that I divide companies are internal versus external drivers. Small caps tend to have more internal drivers. Either they're early in their growth stage, they've made some big investments, or they've made an acquisition and it makes a difference. They have a strong product cycle and so many ways for them to lift the weight being tied to the economy because they're small."

Oberweis: "It obviously depends on the company. For some companies it's going to be a terror. Other companies it doesn't really play a role. For the companies that rely on just innovation, it doesn't really play a role."

O'Halloran: "Yes. Those that are more exposed to commodity costs will have a harder time delivering on their earnings. Product commodity inflation is a problem in those countries where commodities are a much greater portion of the inflation index, but in the United States, commodities are not the biggest factor and arguably they're not a big factor in the inflation measures, so I don't see commodity inflation being a big problem for the U.S. economy."



Tom O'Halloran is director of Small Cap Growth Investments at Lord Abbett. He is responsible for managing the firm's small cap and micro cap growth products, overseeing the investment teams, and directing the investment strategies. O'Halloran has been in the investment business for 20 years.

"Most importantly, commodity inflation is in the process of reaching a peak. Going forward these commodity prices seem unlikely to sustain themselves and inflation [associated with these commodity prices] should peak and begin to turn down. Companies that are more exposed to commodity cost pressures will have a more difficult time this year."

Are you at all worried about inflation?

Lisanti: "We're just starting to deal with inflation. We're in the middle of guns and butter; we did exactly what you're not supposed to do. We did guns and butter in the Iraq war; we had a president who refused to sign a deal on any spending bills. This is exactly what Johnson did with the Great Society in the Vietnam War. The results are always highly inflationary."

"However, now we have secular forces going forth in a positive way that we didn't have in the '70s that were negatives. In the '70s, our productivity was the lowest around the world, our salaries were the highest, our spouse's benefits were the highest — we were uncompetitive. That's not the case today, but until we get it under control, we're going to have to live with 3% to 5% inflation for a while."

"Inflation has actually been good for small caps — even the 20% that we saw in the '70s was good. The reason it's good for small caps is that they are differentiated enough and are able to raise prices."

"A good example is Panera Bread Company (Nasdaq:PRNA). It's raising prices in a sneaky way — by raising bagel prices by \$0.50 and coffee prices by a quarter. That nets out to about 4% to 5%, and this is what a lot of small companies are doing although they couldn't do it if people didn't enjoy the overall experience. They can't raise prices 10%, but they can raise them 5% or 6% because they're not competing around the globe, only in the United States."

"They also have better control of their costs because they pay their people with stock as well as cash. The structures are different. These are all things that work for them now that didn't work for them the last four or five years."

Oberweis: "The question in my mind isn't really about inflation. It's 'Am I more worried about inflation than everyone else?' That's what affects equity valuations. It's actual valuations in respect to expectations."

Everyone is thinking about it and that's already probably accounted for, at least partially, in stock market prices."

O'Halloran: "I do not believe we have an inflation problem in the United States because nearly two-thirds of inflation in the United States is labor. There is no labor inflation in the U.S., especially as unemployment is ticking up."

Riley: "I'm worried about inflation in terms of operating cost for a company; it's gone up, and that's going to have an impact on earnings."



Bryant Riley is founder and managing member of Riley Investment Management, an investment advisor which provides investment management services. He also is founder and chairman of brokerage firm B. Riley & Co.

Wyatt: "My primary concern with inflation is related to the economy as a whole. Capital markets do not operate outside of the general economy. As the economy goes, so too does everything else. We have a real problem with inflation today, but as evidenced by their recent actions, I believe the Fed sees inflation as a bigger risk than an economic slowdown. I'm in agreement."

What about stagflation?

Lisanti: "Small caps did great [in periods of stagflation]. In a secular bear market, after you hit your lows, secondary growth stocks do really well — and that's what we're doing. That's what's outperforming. [Stagflation] doesn't matter to [small caps] at all for the same reasons that high inflation doesn't bother them."

Oberweis: "If stagflation were to occur, I think some companies would have products or services that would not be as strongly influenced as others. The areas that are most likely to be least influenced would be companies with innovative products or services that people are going to buy irrespective of market conditions. If you have a better mousetrap, people are probably going to buy it, whether economic times are good or bad. That doesn't mean that the company wouldn't do even better if economic times were good, but companies with innovative products or services that people need tend to be the least-influenced area."

O'Halloran: "If we have a serious case of stagflation, the current equity valuations are not as attractive as they appear. If we have an inflation problem, then interest rates would have to rise and these P/E multiples that look attractive at current interest rate levels would be an illusion. My view is that inflation will moderate, and that stagflationary conditions will be short-lived."

Riley: "[Inflation and stagflation are more] relevant to larger companies. I spend less time focusing on the macroeconomy. I want to be in more company-specific situations where that mentality is already priced in. We're trying to focus on specific situations where this is reflected in the valuation."

Evans: "Yes, absolutely [stagflation is a concern]. We have a very sluggish economic environment— 1% to 2%-type of GDP growth. When you think about inflation running 3%, 4%, or 5% on a headline basis, that's negative real GDP."

"You need to be focused on companies that have the wherewithal to raise prices and can take advantage of the pockets of strength within the economy."

How big of an issue is the weak dollar for small caps?

Lisanti: "The weak dollar is not a big issue, but for the overall market it is not a positive. I think the dollar stabilizing is a positive for small caps because it solidifies relative earnings growth. As the dollar stabilizes, which is what's currently happening, much of the large multinational earnings growth (half of which has come from the euro) will disappear. This is because even when small caps export, they don't tend to manufacture in those countries. Earnings growth will go back to single digits, but small-cap guys are not as exposed to the dollar."



Brad Evans is a portfolio manager of the Heartland Value Plus Fund and the Heartland Value Fund for Heartland Advisors. Evans is a Chartered Financial Analyst and has more than 11 years of investment industry experience.

Oberweis: "For companies that are importers, it is a big issue, but for exporters it's a terrific benefit. We really have to look at the business. We own some businesses where inflation's a positive — it doesn't hurt them at all. If a company has fixed costs, the contracts essentially lock in the cost over a long period of time. Then they may like inflation because it increases their nominal margin. Obviously, if it's prolonged for a sustained time period, then it could be a different story."

O'Halloran: "It's less important than for large caps because large-cap companies are more international in their business. Because of the development of the emerging nations, the ease to manufacture abroad and the advent of the Internet, which enables small caps to get their products or services to an international audience much quicker, small caps have become more international than in the past. It's less important than for large companies, but it's a good deal more important than it used to be for small-cap companies."

Riley: "The weak dollar is going to be a benefit to some. You're going to see foreign buyers for many of these small companies. It's going to counteract because the dollar has put everything on sale. The weakness in the dollar is hard for a company where that's not the end game. Inflationary issues are more meaningful in a smaller company. You're going to see pressure to sell and consolidate, and that consolidation is going to be in the form of smaller companies getting bought. The valuations reflect a huge negative mindset out there; when companies are sold, you're going to see them sold at meaningful premiums from there."

Wyatt: "Really this is a question that is firm-specific, but generally speaking, a weak dollar tends to have more of an impact on small caps than mid and large, because larger firms are more likely to have foreign currency exposure, unless of course, the small cap is concentrated in its revenues toward foreign currency exposure."

What effect will the presidential election have on small caps?

Lisanti: "It depends on the policy. People will focus on what happens to the incremental tax rates. I don't think that's going to matter as much as the policies and [their effect on] the economy. If we end up in a situation where we have many policies that are detrimental to the economy and economic growth, it will hurt small caps. I will preface this by saying I have no personal opinion. I'm a registered democrat but I vote how I will. If we end up with a typical tax-and-spend democrat it won't be good because it would slow the economy further. The economy will be fragile for some time, and so [the new president needs] to make sure that [he doesn't] kill the patient."

Oberweis: "I think the area that I find most affected would be government contractors and defense organizations. It takes a while for presidential policies to sink in and take effect."



Ian Wyatt is Chief Investment Strategist for SmallCapInvestor.com. As a well regarded small cap stock expert, Ian also serves as the Editor-in-Chief of two independent investment newsletters, Growth Report and Rising Star Stocks.

O'Halloran: "I think it will have a very bad effect on the overall market if Barack Obama is elected. I think that will mean higher taxes and, a bigger role for government in the economy that would be greeted with a sell off in the market. It is an important issue. I think that the health-care sector could suffer if Obama gets elected because people will be nervous about nationalized health care and what it would do to some of the companies in the sector. He would seek to raise the income and capital gains taxes. He has an agenda to redistribute wealth, and to create a greater role for government in the economy. This would be bad for the economy and equity markets."

Riley: "I think that there is going to be pressure on taxes. One of the things companies think about is 'We've got cash on our balance sheets. Do we take advantage of the current dividend tax structure because there are some concerns over what would happen in an election?' There's also uncertainty and the markets typically correlate with uncertainty."

Will we see more equity issued as a whole or for that matter buybacks during the remainder of the year?

Lisanti: "That's more of a 2009 issue than it is a 2008 issue. You're going to see some of them store it, some doing buybacks, some making acquisitions and some giving out dividends. By and large, however, small-cap companies want to hold onto their cash because they want to grow. Two reasons: one, they want to grow and two, they never want to be caught where nobody wants to lend to them. These guys are in the early stages of the life cycle, so they're not at the point where they should be distributing their cash anyway."

Oberweis: "Historically the market has tended to issue equity when valuations are high. Within the small-cap marketplace they're among the lowest that we've seen for a long period of time. Unless you see a change in market valuation, I wouldn't expect to see a high number of syndicate items."

"That said, we are seeing not only buy-backs, but management coming in and taking personal positions in many of our companies. That's usually a good sign. Management doesn't always have it right, but they probably have a better perspective than you or I on the individual company in which they're involved. If they have the confidence to be jumping in at these current levels, those are positive characteristics."

O'Halloran: "The financial sector has to raise equity to recapitalize their balance sheet. They will probably have to do so at lower share prices to attract the capital. There will be an opportunity for companies that are exhibiting fundamental strength to come to the equity markets — companies in energy, materials and those that produce durables will have an opportunity to raise money.

"Companies in technology will probably only come to the market if the overall equity market improves; if it improves then technology will probably do better. We could see deal activity in technology. There's been a lot of venture capital going into tech over the past five years. The companies have had a lot of time to develop and there is good quality ready to come out. If the market gets better, we should see more tech IPOs. In total, there should be plenty of equity issuance.

"There should also be much buyback activity because companies have significant cash and their stock prices are now at more attractive levels than they were a year ago."

Riley: "We're focusing on well-capitalized companies and the majority of those are buying back stock. I think we'll see that continue. I'd hate to be a small-cap company in need of capital because I think that's a very challenging environment."

Evans: "It seems like a lot of the deals have gotten shelved. The markets are not open right now to new equity issuances of any kind other than in the area of energy and, as I said before, there have been a number of capital raises in the financial banking area. That window now looks to be closed as a result of most of the deals that were done to recapitalize the investment banks and the regional banks that are now under water. I think most small company management teams today realize that liquidity is king. Right now it's a fairly tenuous environment from a capital-raising perspective, so I don't see a lot of capital raises right now in the short term, but that could change. Surely there'll be a lot of pent up demand."

Wyatt: "It'd be foolhardy to issue equity under these conditions. People just aren't willing to pay very much. On the other hand, if a firm believes itself to be undervalued, which I think many may feel they are at this at point, then this is an opportune time to buy."



About the Author

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