A person wearing a plaid shirt and a wide-brimmed hat is fishing from a boat on a lake at dusk. The person is seen from the side, holding a fishing rod. The background shows a calm lake and a dark, hazy sky. The overall tone is purple and blue.

# The Case for Microcaps Investing

# Microcaps

Microcap describes the share market segment of the smallest investable stocks.

While exact definitions vary, the representative market capitalisation for Australian Microcaps is stocks below \$500 million. On the Australian Stock Exchange (ASX), this segment has over 1900 companies.

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# The Case for Microcaps Investing

## Why Microcaps?



### **Under Researched**

Disciplined research approach can add value and reduce risk



### **Inefficient Sector**

Median Manager delivered 18.8% p.a. over 5 years\*



### **High Growth Opportunities**

Capture companies early in their growth cycles



### **Diverse Sector Exposure**

Large universe allowing access to most sectors

\* February 2017 Mercer Survey

As experienced investors, we are attracted to the Microcap space for a number of important reasons:

- It is a **large and diverse universe**, so as fund managers we can find the exposures we want rather than be forced into any one sector;
- It is **poorly covered**, providing an opportunity for excess returns when a proven and disciplined research process is applied;
- It provides **access to early stage companies** which are growing their earnings strongly,
- The company's Management and Board usually own a large percentage of stock, **aligning their interests with fellow shareholders**,
- Is a hunting ground for corporates, so investors can often benefit from **increased takeover activity**.

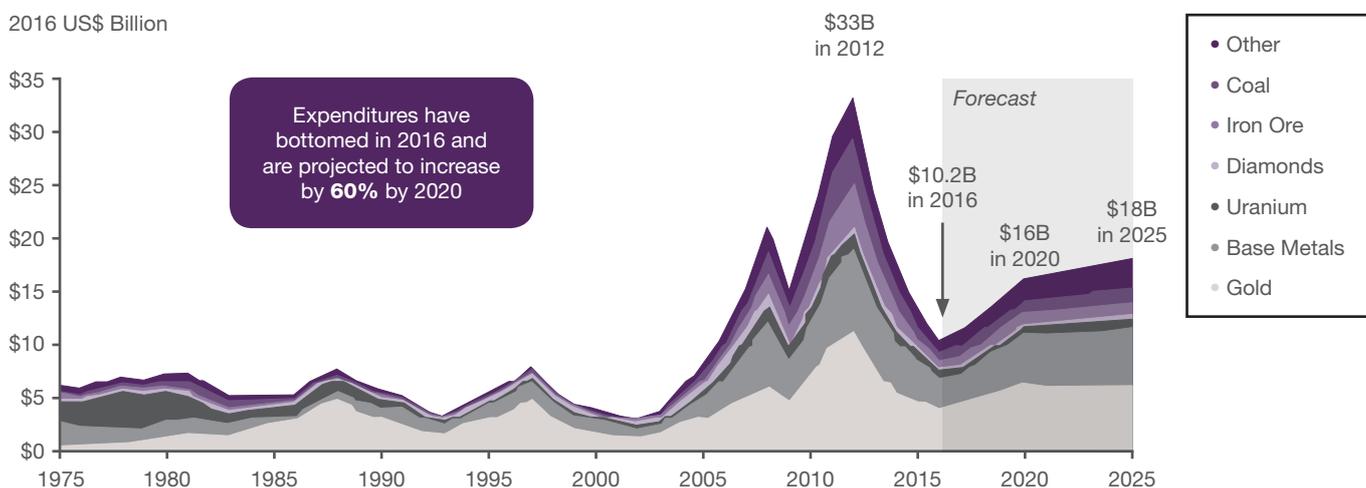
An important advantage of being a large institutional investor like Perennial Value, is that we have **access to the majority of Initial Public Offerings (IPO's) and pre IPO opportunities** in the market.

## Large and diverse universe

Unlike the Top 100 segment of the ASX, which is dominated by banks and major resource companies, the Microcap universe is very diverse ranging from mineral exploration companies to social media platforms and anything in between. Companies tend to focus on one market or product (such as RPM Global which provides software to mining companies) or niche sector (such as Ellex Medical Lasers which provides equipment to treat eye disease) rather than the conglomerates found amongst larger companies. As a fund manager we can position the portfolio to take advantage of obvious themes without being forced into unattractive sectors just because they are part of an index.

As an example, there are several microcaps through which an investor can get a direct and undiluted exposure to mining exploration. We believe mining exploration sector is in the early stage of what is likely to be a multi-year recovery as shown below.

### Forecast exploration expenditures: World by Commodity: 1975-2025



Source: MinEx Consulting March 2017

Companies exposed to this sector will experience very strong earnings and consequently share price growth. To get exposure to this recovery, investors could invest in Imdex or Swick (both of which are held in the Microcap Opportunities Trust). These businesses have strong intellectual property, industry leading margins and are both solely focused on exploration and resource drilling.

Another example, is also the current East Coast gas shortage in Australia, which has recently made front page news. Companies that will directly benefit from this and have excess gas reserves are in short supply. In the large caps sector of the ASX, AGL has some leverage but also has retail distribution, while companies such as Santos and Origin are locked into offshore gas exports contracts.

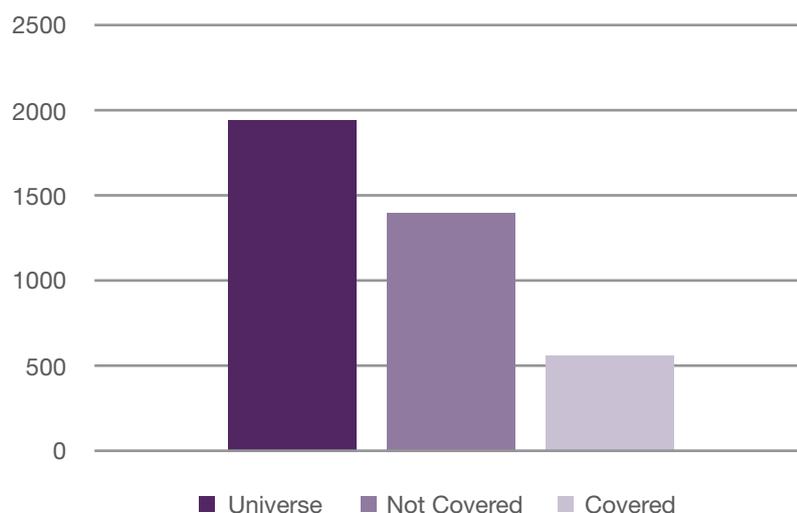
In Microcaps by contrast, Cooper Energy has positioned itself to take advantage of the situation by significantly increasing their exposure to East Coast gas with the acquisition of the Sole assets (from Santos as part of their balance sheet repair), and as a result will be able to profit from the current supply shortages. This process has been five years in the making and one that we have been watching closely. We have now added Cooper Energy to the Microcap fund. As this plays out, Copper Energy is unlikely to be a Microcap for much longer.

As evidence of this growth potential in the past we identified telecommunications as a growth sector which was under appreciated by the market. Two of these investments have grown from Microcap to top 100: SPTelemedia (which renamed to TPG Telecom) and Ammcom (acquired by Vocus).

## Poorly Covered Universe

The graph below illustrates that there are 1945 companies outside the Top 100 with almost 1,386 (71%) of these having no broker coverage.

### Broker Coverage of the Microcap Universe



Source: FACTSET Bespoke Universe Screen

Further analysis shows a very low number of analysts per stock in Microcaps, particularly compared to the Top 100.

	Top 100	Small Ords	Microcaps
Average No. of Analysts Per Stock	12.7	6.3	0.4

This lack of coverage means stocks are less likely to reflect their intrinsic value. The interpretation of company results and announcements is also less sophisticated, creating obvious valuation gaps which can be close over time.

At Perennial Value we aim to take advantage of these gaps and add value for investors. As a company grows its earnings, its valuation will increase, broker coverage will rise and investors will follow. This will result in the valuation gap closing.

# How do you identify the best stocks in such a large universe?

At Perennial Value we use our proven research approach to discover stocks that are poorly understood but have strong prospects and solid management teams. Our team spends equal time between conducting thorough company meetings and building relationships with the management teams and analysing the numbers.

**UNIVERSE SCREENING**      **FUNDAMENTAL RESEARCH**      **PROPRIETARY RANKING (Perennial Value Screen)**      **PORTFOLIO CONSTRUCTION**      **CLIENT PORTFOLIO**



- Large company visit program to identify opportunities
- Screen for:
- For stocks not covered screen historical data on EV/Sales, strong cashflow
- If covered screen for better value than market on forward multiples (P/E, EV/EBIT)

- Characteristics sought:
  - Sound financial position
  - Good management
  - Profit track record
  - Strong market positions
- Capital preservation
- ESG
- Company visits
- Peer reviews

- Focus on five key measures sourced from company models
  - P/E
  - P/FCF
  - P/NTA
  - Net interest cover
  - Forecast 3yr EPS Growth
- Stock ranked best to worst value

- Determines every stock's weighting
- Function of
  - Risk Limits
  - Liquidity
  - Conviction rating
- Sell Discipline

Source: Perennial Value Management

An example of our process at work is when we identified the Tourism sector as a beneficiary of the falling Australian Dollar several years ago. Sealink provides a direct exposure to this sector of the economy and we consequently participated in the IPO becoming the largest shareholder and have enjoyed the strong re-rating ever since.



Source: Perennial Value Management, IRESS. As at 31 March 2017

## Identifying Microcaps to Avoid

To identify which potential Microcaps to avoid we focus on a company's balance sheet. The key method of reducing risk is to focus on those companies with minimal debt or ideally large net cash balances (particularly if the company has a limited financial history).

Given the almost 2000 companies in our universe we run several screens (on historical and broker forecasts if available) to filter out concept stocks so we can then focus our research efforts on quality ideas in growing sectors. In addition to these screens we are on the road a lot, as a team we did over 700 company visits last year.

Once we have identified the best ideas we do detailed modelling and put together the best value portfolio of close to 50 stocks.

# Conclusion

Whilst we believe there are many opportunities for good investments in Microcaps, often the size, diversity and poorly covered nature of this universe can make it difficult and daunting for direct investors. For many it can be akin to heading into uncharted waters. Many are attracted to the sector given stories of strong returns but many are also turned off by poor experiences and the heightened risks.

This is where professional fund managers can help!

With the Microcap Opportunities Trust, investors are able to benefit from the considerable experience of Perennial

Value who applies a disciplined and proven research approach in this neglected part of the market.

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#### 2017

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