

Market View: SITS companies – Perspectives in challenging times

For the first article of the series Westchester invited independent analyst Ian Spence (see left side panel) to comment on how SITS (“Software and IT services”) companies are faring in the public arena especially those on AIM. Not only are their valuations of great importance to their shareholders and stakeholders but these same valuations greatly influence the exit values of private company trade sales. Furthermore these companies have been the potential buyer for many private companies. Their health affects all. What follows is an independent perspective and does not necessarily coincide with Westchester’s own view.

Don’t get stuck in the micro cap cul-de-sac

Whilst there has always been a valuation differential between large and small stocks, over the last couple of years, I believe that the stock market has become increasingly schizophrenic in its appraisal of technology companies where the subject of market cap is concerned. There are numerous examples of larger companies achieving valuations many times greater than a smaller quoted peer, even if the two companies operate in similar parts of the technology sector. Whilst one could make an argument that there should be some valuation differential for size, the extent of the differential can be put down to technical factors relating to the stock market. These technical factors have led to many companies getting stuck in what I have termed the micro cap cul-de-sac. So what exactly is it, how does a company get stuck in it and how can it get out? The Micro cap cul-de-sac is a place where no smaller listed company wants to be but it is easy to fall into it and very hard to get out. It is a place where the market cap of the company is below where mainstream institutions will invest and where independent analysts cannot make a living from covering the stock. This lack of attention from the City often leads to a terrible drift in a company’s shares which, in turn, pushes the company further down the cul-de-sac. Whilst it is not simply a function of market cap (free float is also a key factor), as a broad rule, companies under £50m market cap are at risk of getting caught in the trap. Once in the cul-de-sac, a company effectively loses the ability to do the one main thing that the stock market is designed to provide – raise capital for growth. Once a company falls below the institutional radar, it is extremely difficult to raise a significant amount of new money from the market. Furthermore, the company’s valuation will have dropped so far that it is almost impossible to make an earnings enhancing acquisition. So the company is stuck: it is too small to be of interest in institutional investors but it cannot execute on an M&A strategy that would enable it to break out of the trap. It’s a classic catch 22 situation.

As the market has weakened, the number of companies stuck in the cul-de-sac has increased significantly. The average valuation for the Megabyte Fledgling Index (an index which includes 50 companies with a market cap of around £10m to £50m) was 10.3x at the end of July. However, the median valuation was just 8x current year earnings and there are a small number of stocks with a PE below 5x. Moreover, there are over 70 companies below £10m market cap in the sector; the vast majority of which are well and truly stuck in the micro-cap cul-de-sac.

As a way of trying to break out of the cul-de-sac, many companies have used bank debt to fund acquisitions but the credit crunch has effectively put paid to this. Even if companies do have access to further bank debt, investors are increasingly nervous about geared smaller companies further adding to the vicious circle. The other obvious way out is for companies to put themselves up for sale. Indeed, sub £50m market companies have made up about half of the takeovers in the sector by number in the last

12 months. However, this still leaves well over 100 companies in the sector either in, or in danger of entering the micro cap cul-de-sac and, for most, there is no obvious solution to the problem.

As with any issue like this, I believe that the first step to recovery is for the boards of these companies to accept that there is a fundamental problem. "My name is XYZ plc and I am stuck in the micro cap cul-de-sac". Once the CEO has faced up to this fact, he then needs to look around for like minded companies with whom he can combine. Whilst consolidation in this way is far from a panacea, it is the only realistic way for companies to fight their way out of the cul-de-sac in the current market environment.

Some companies might see one option as ploughing on with an organic growth strategy. However, in my opinion, this is not a viable option. One consequence of the cul-de-sac which I have witnessed many times is that the company's best people get increasingly de-motivated by the lack of share price momentum, especially if their share options are under water, and perform poorly or leave. This clearly makes the effective execution of an organic growth strategy almost impossible.

As for companies with less than £5m in profits thinking of coming to the market, I have a simple piece of advice. Don't. Rather than being a liquidity event that will deliver value for shareholders and create a platform for growth, a micro cap listing can simply be the beginning of a long slow decline for the company. Depending on the shareholders' objectives, either a private equity round or trade sale is a much smarter option.

Ian Spence – September, 2008

Ian Spence has been involved in researching and raising money for companies in the technology sector for over a dozen years and was voted TechMARK analyst of the year in 2004. In 2007, Ian set up I S Research, a niche research consultancy which monitors the corporate and financial affairs of software and IT services companies operating in the UK. The company's research is published primarily through the widely read market intelligence service Megabyte.



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