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Mining for gems among the overlooked small caps

By Whitney Tilson
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I have never believed that large-cap stocks are too well followed to be anything but efficiently priced. In fact, over the past two years I have added significantly to my holdings in big, exceptional companies that the market seems to have lost interest in, such as Microsoft, Wal-Mart and McDonald's.

But that hasn't stopped me looking for undiscovered small-cap gems – with market capitalisations well below $1bn – which is where I have made most of my money.

Cannell Capital's Carlo Cannell, one of the best small-cap investors in the business, describes his job this way: "We try to uncover promising turnrounds, dullards and assorted investment misfits in the underbrush neglected by the investment community."

Small-company stocks, like any asset class, can get picked over from time to time but there are fundamental reasons why diligently mining them with an eye for unrecognised value can get market-beating returns.

One is the increased relative upside available when starting from a smaller market value. Motley Fool recently identified 325 stocks that provided annual shareholder returns of more than 20 per cent over the past 10 years and found 296 of them, or 91 per cent, were small-caps before they grew to greater prominence.

More than 80 per cent of all companies traded on US exchanges lack consistent research coverage, defined as having no more than three sell-side analysts publishing earnings estimates. This increases an investor's chance to develop an advantage.

A few years ago, Weyco Group, which designs and markets shoes, acquired at an extremely low price the well-known Florsheim shoe brand, which promised to double earnings. With no analyst coverage, the stock scarcely budged on the news and I was able to visit management, understand the implications, and buy the stock. Sure enough, earnings have doubled, as has the stock. This highlights another advantage of investing in small companies: good access to management. Bill Gates won't take my calls but the chief executive of Weyco will.

Footstar, one of my favourite small-cap ideas, illustrates a fertile area for exploration: stocks that have recently emerged from bankruptcy. It is a discount footwear retailer operating licensed footwear departments in Kmart and Rite Aid stores and is best known for its Thom McAn brand. It has been through bankruptcy at least twice as a result of terrible strategic decisions and acquisitions.

The business has historically been structured as a joint venture between Kmart and Footstar. The two disagreed about the future of the business, sued each other and then reached a settlement that allows Footstar to operate in Kmart stores for at least three years, paying a percentage of revenues as “rent”. Kmart can then terminate the relationship but only by purchasing Footstar’s inventory.

The stock has recently traded around $4.65 and I think it is worth nearly twice this. It is relatively easy to value, as there are only a few simple components: Operating cash flow, which I estimate will be $60m over three years; Footstar’s inventory that Kmart must purchase at book value – which I estimate will be $54m – if it terminates the agreement at the end of 2008; and a company-owned office building that was appraised in October 2004 at $20m. Footstar also had net operating losses as of January 2005 of $164m. These would be attractive to any potential acquirer if Footstar winds down its business, so I value them at $40m.

Add it up and I estimate Footstar’s value at the end of 2008 at $174m, about $8.50 per share.

The potential rewards of small-cap investing do not come without risk. For every American Eagle Outfitters or Pool Corporation – which have returned about 50 per cent a year for the past 10 years – there are legions of small companies that die a painful death. The relative illiquidity of small-company shares – which often contributes to their being undervalued – also increases their volatility.

But overall when it comes to investing, small can be beautiful.

Whitney Tilson is a money manager who co-edits Value Investor Insight and co-founded the Value Investing Congress.

E-mail: feedback@tilsonfunds.com