Microcap IPOs: An Underappreciated Opportunity

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Despite the pause in IPOs seen earlier this year, low interest rates and a strong market for growth stocks have made for a fertile IPO market in 2020. There have been a handful of high-profile companies that have recently gone public at high market caps leading to speculation that companies are not going public until they are larger in size. Pundits would have you think that companies no longer go public at small and microcap valuations, however, the empirical data suggests otherwise. In this whitepaper, we will dig into these headline narratives and explore the IPO market from both a performance and market capitalization perspective.

Entrepreneur Richard Branson said that “a big business starts small”. That may be the case while stocks are in the idea phase or begin their life as a private entity, but it is not always the case once shares become available to the public. Many companies that have garnered press recently have entered the public markets with valuations in the billions. That said, we do not believe companies en masse are avoiding going public when they would fall within microcap and small cap. We also refute that the strongest returns have been from companies that went public at high market caps. We feel the handful of recent exceptions are more representative of overcrowding in private equity, frothy markets, and the rare but lucrative quest to find ‘disruptive’ companies early as opposed to meaningful structural shifts. While these large stocks gain the headlines, the data highlights the opportunities for active managers trafficking in small stocks. At Acuitas, the investment managers we allocate to in U.S. microcap closely monitor the IPO market in an effort to generate new investment ideas and opportunistically participate in select new offerings when the stocks are appropriate for their investment discipline.

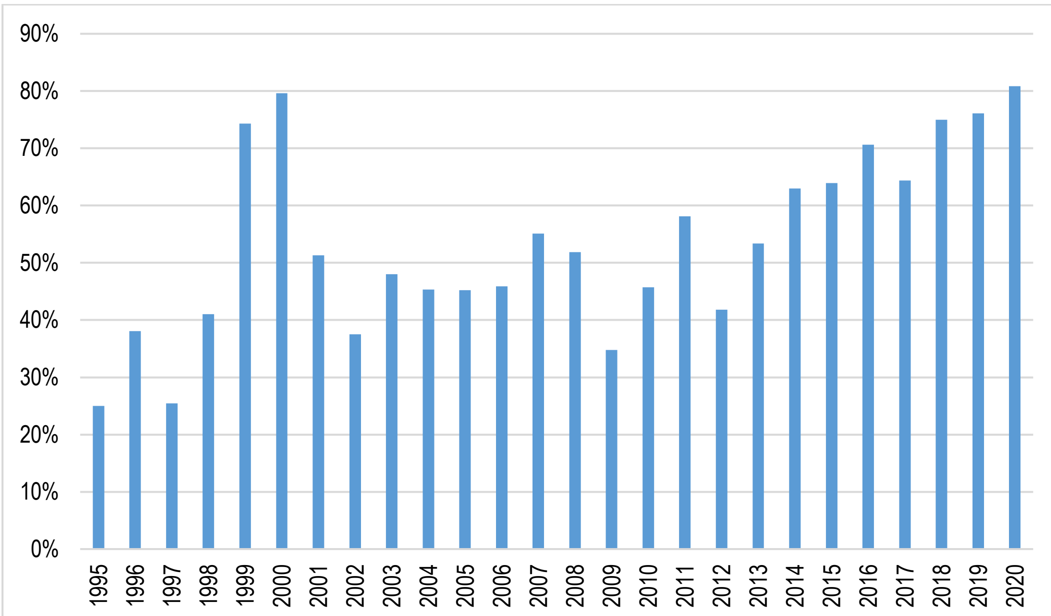
While small company IPOs do not often draw headlines, there has been a robust microcap IPO market. Our data will show that there continues to be a high number of companies going public in the microcap space. The increase in special purpose acquisition company

(SPAC) deals, while not as appealing to some when they first come to market, also increases the supply of smaller public companies.

A word on SPACs. The year 2020 has been called the year of the SPAC. For those less familiar, a SPAC occurs when founders raise capital in a public company with the intent of buying another company, often a private company, with the money they raise. Founders have 24 months to complete a deal. The benefit to SPACs includes a more efficient process for private companies to go public, which is time consuming and expensive, and the ability for private companies to partner with management teams that have experience in public markets. The process is not without challenges though as sometimes heavy debt loads can combine with governance and regulatory challenges for companies that have not yet navigated public markets. Through October 20th, gross proceeds from SPACs in 2020 were $56 billion, versus $13 billion raised in all of 2019. One of our investment managers perhaps put it best when he noted that there can be "a lot of wood to chop" even after a SPAC makes their acquisition. He is like many active investors who prefer companies with proven business models trading at a significant discount to the private market. For our analysis, we removed SPACs from our data to get a pure outlook of the investable IPOs that most active managers prefer.

The IPO market is frothy. It is important to note that we are not in a normal market for IPOs. At the beginning of the pandemic, IPO activity ground to a halt, but with market stabilization came a large number of IPOs. We would note that the market has been robust and perhaps over-extended when you take into account the type of companies going public. One metric we follow is the profitability of the companies going public. We have seen IPOs of companies with no revenue, no earnings and barely a dozen employees with valuations in the hundreds of millions. Looking back at the peak of the dot-com bubble nearly 80% of IPOs had negative earnings. Looking year to date 2020, we have exceeded this record. Over the last 25 years, a typical average of IPOs with negative earnings was 25-40%, but that number has been steadily rising since 2012. The chart below highlights just one reason why investors are noting market parallels to the late 90s.

Exhibit 1. % of IPOs with Negative Earnings



Source: FactSet; Acuitas Investments

2019 saw many small IPOs. During 2019, there were a total of 194 IPOs. Nearly 80% of them were below $1 billion in market cap and over 43% of them were in the $250 to $1 billion market cap range, roughly in line with our investable microcap universe. In contrast, there were only 19 IPOs over the $3 billion mark – less than 10% of the IPO universe – yet these companies attract much more than their fair share of press, which gives the impression that the only companies going public are those with existing multibillion dollar valuations. We can understand the attention given the high-profile nature of the deals and amounts of capital at stake, however investors focused on forward looking returns might be better served focusing on smaller, more investable ideas that have a clear growth trajectory.

Exhibit 2. Number of IPOs by Market Cap (2019)

Market Cap Range (MM)	Number of IPOs in the United States (2019)
0-250	68
250-500	63
500-1000	21
1,000-3,000	23
3000+	19

Source: FactSet; Acuitas Investments; FTSE Russell

Microcap IPOs have generated strong short-term returns. We looked at the returns for microcap stocks that came public in 2019 and divided up the sample size into cap tiers. For purposes of this analysis we removed those companies without reported market caps and returns, shrinking the number of observations. We also removed SPACs and targeted acquisitions to hone our analysis on true IPOs. Despite the recent continued outperformance of large cap stocks over microcap in general, small IPOs have performed well over this short time frame. As seen below, there is a robust number of IPOs and potential return opportunity found in the $250-$1,000MM range (the heart of the microcap space). Importantly, the $0-$250MM market cap range is influenced by those IPOs under $100MM in market cap, a space where we typically have very little exposure. These companies also do not make up a meaningful portion of the institutionally investable microcap universe.

Exhibit 4. Average 3-Month Return Since Offer Price by Cap Tier

Market Cap Range (MM)	Average 3-Month Return Since Offer Price	Number of IPOs
0-250	7.6%	36
250-500	**33.3%**	**34**
500-1,000	**27.9%**	**18**
1,000-3,000	48.0%	23
3,000+	29.7%	19

Nearly 65% of the Acuitas Microcap Composite is invested within the 250-1,000MM range.

Source: FactSet; Acuitas Investments; FTSE Russell
*Excludes SPACs and those without reported market caps and returns.

Microcap IPOs have generated strong long-term returns. The recent short-term performance is not an anomaly. Shifting our focus to long-term returns from IPOs, the chart below shows total returns since the offer price of each company. Over the past 20 years (12/31/1999-12/31/2019) there have been robust returns across market cap ranges. Focusing on the microcap opportunity set, $250-$1,000MM, not only are there a significant number of IPO opportunities, the historical returns on the broad opportunity set are appealing. It is also important to note the much smaller sample size of IPOs from the largest cap tier where just a few stocks are heavily influencing total returns (removing just the five top performers in this group drops this return to 91%).

Exhibit 3. Average Total Return Since Offer Price by Cap Tier (Returns Through 9/24/2020)

Market Cap Range (MM)	Average Total Return Since Offer Price	Number of IPOs
0-250	63.0%	1,052
250-500	**156.8%**	**777**
500-1,000	**131.1%**	**522**
1,000-3,000	152.9%	438
3,000+	197.6%	155

Nearly 65% of the Acuitas Microcap Composite is invested within the 250-1,000MM range.

Source: FactSet; Acuitas Investments; FTSE Russell. 12/31/1999-12/31/2020
*Excludes SPACs and those without reported market caps and returns.

Many of the recent leading IPOs started small. The last two years have seen some of the largest IPOs on record, causing many of these names to garner significant public attention around their IPOs. Despite the fanfare, the best performing IPOs have not been the largest. The top ten IPO performers (as measured by total return since offer price) have an average market cap at the time of their IPO of $1.57 billion. A total of six out of the ten are under $1 billion in market cap, which is commonly defined as microcap. While these companies may not have grabbed the headlines, investors seeking returns would have been well served to keep an eye on many of the smaller IPOs.

Exhibit 5. Top Ten IPOs of the Past Two Years

Company	Total Return Since Offer Price	Market Cap at Time of Deal (MM)
IPO #1	1201%	9,229.98
IPO #2	558%	339.38
IPO #3	519%	225.00
IPO #4	495%	1,457.70
IPO #5	478%	1,495.53
IPO #6	461%	1,587.59
IPO #7	458%	185.90
IPO #8	425%	462.27
IPO #9	412%	365.73
IPO #10	402%	361.22

Source: Acuitas Investments, FactSet, FTSE Russell. 9/22/18-9/22/20

We also observe and track the participation of our managers in the microcap IPO market. As we previously noted, many of the investment managers we have allocated to monitor IPO activity and view it as a good opportunity to get familiar with a company. While they occasionally participate, they will usually wait until post-IPO to invest due to the early stage nature of many companies and volatility that usually follows IPOs. That said, we have seen a decent number of our investment managers participate directly in IPOs as delineated below.

Example 1: Restaurant Chain - $114 million market cap. IPO priced at $14 and the stock ran up to over $28. Company operates as a small chain of 22 restaurants in the US but is owned by a much larger parent. We had a manager participate in the IPO.

Example 2: Cloud Software Company – Shares were initially priced at $21 (above the expected range of $16-18 in filings). On the first day of trading the stock nearly doubled to a high of $39.56. Cloud software company that assists with assessing customer satisfaction. This company was a bit larger which led to a larger allocation for one of our managers. This was an interesting example in part because our manager was allocated shares of IPOs based upon its reputation as a sophisticated and longer-term investor.

Example 3: Furniture Company – $450 market cap, $165 million in sales in 2019. IPO priced at $16, current price is around $25. This is a company a couple of our managers have purchased. Returns have been volatile, but they have effectively pivoted to online and phone sales during COVID. The company makes stylish and modular furniture. It went public in 2018 and nearly tripled in its first year.

Summary: We hope that the takeaway from the data we have presented highlights to investors that the microcap IPO market remains healthy and is a steady source of new potential investments for active managers. Small stocks continue to enter the public markets through standard IPOs and importantly, the performance of those stocks that start in the smaller cap tiers has been strong. For investors we hope this paper dispels the myth regarding the lack of small IPOs that represent good investment opportunities. We strongly believe it simply is not the case that the biggest IPOs are the best IPOs.