U.S. Microcap Poised to Benefit from Rebound in M&A

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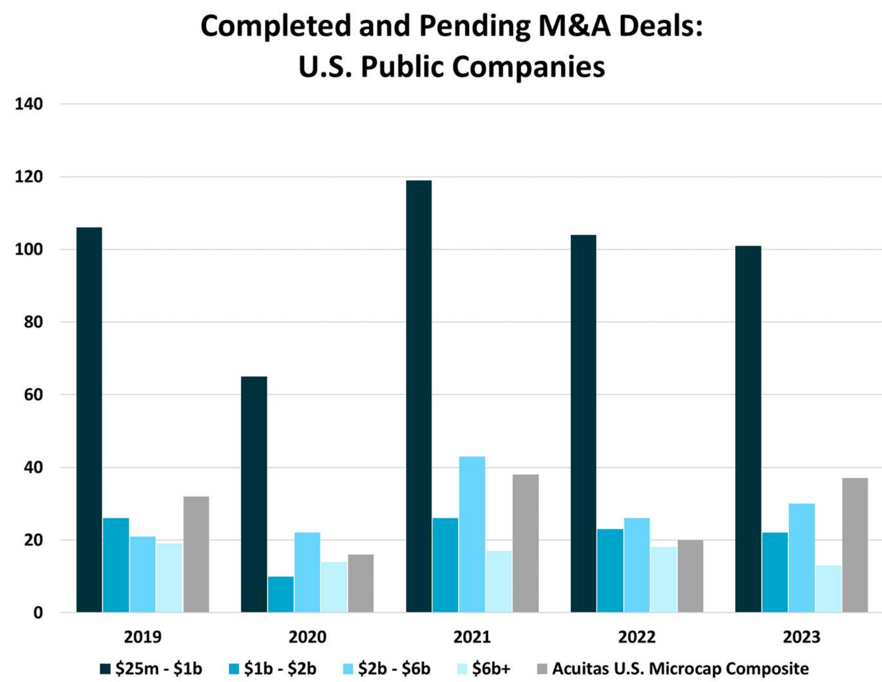
When Acuitas was founded in 2011 we chose to only invest in inefficient markets, including microcap equities, due to the unique return opportunities available for skilled active managers in those areas. Among the unique return drivers in microcap is the frequency and impact of mergers and acquisitions (M&A). In short, smaller, less efficiently priced securities are a lucrative place for acquirers to find attractive takeout targets. As a result, microcap companies are taken out more frequently and at higher premiums than any other market cap tier, generally improving returns for microcap investors. Given the value of mergers and acquisitions in microcap, we periodically reassess the environment for M&A and the performance boost they have provided for microcap investors.

Although M&A still had a positive impact on performance for microcap managers in 2023, there were headwinds that dampened M&A activity, mostly due to the surge in interest rates and concerns about a recession. However, optimism is growing that we are likely to see a friendlier environment for M&A in 2024. Positive factors include the expectation that rates have peaked and will trend lower, increasing confidence that the U.S. has avoided a recession, the onshoring of supply chains, and very high levels of cash at private equity firms and on corporate balance sheets that needs to be put to work. With optimism growing that the M&A environment is improving as we move into 2024, we think it is an opportune time to revisit our analysis.

The chart on the next page shows the aggregate number of takeouts over the last five years based on the market capitalization of the company being acquired. There is a stark contrast across buckets, with more takeouts in companies below $1 billion in market cap than all other capitalization tiers combined. The data is compiled from U.S. based public companies that were M&A targets with a minimum market cap of $25 million, as well as any additional securities held in Acuitas' microcap portfolios. Any deals with incomplete data are excluded, and only deals that were completed or those that have been announced but not yet completed are included. As a note, a few takeouts within our portfolios were technically headquartered outside the U.S., but their businesses were U.S. based and therefore part of our investment universe. The market cap buckets highlight our area of focus in microcap (sub $1 billion) relative to other cap tiers. Of course, the microcap universe does extend above $1b (as of 12/31/23 roughly 18% of the Russell Microcap Index was above $1b), so the $1b-2b bucket captures some larger microcap companies, but the bulk of where we focus is captured in the sub $1b bucket.



Source: Acuitas Investments, FactSet

It is always interesting to update this data to see if any recent trends emerge. What immediately stands out is the notable dip in activity during 2020, which is understandable given the COVID pandemic. Interestingly, the second quarter of 2020 is the only quarter in the last decade where Acuitas' U.S. microcap portfolios did not have a takeout. The temporary pause during COVID certainly contributed to 2021's recovery in activity, however the key long-term trends remain intact (the average of 2020 and 2021 is very much aligned with the other years). Most important is that year after year, the frequency of takeouts remains far greater in microcap than any other place in U.S. public equity. Additionally, Acuitas' portfolios have been effective at identifying and capitalizing on the return tailwind provided by the robust M&A activity within microcap, as shown by the gray bar in the chart.

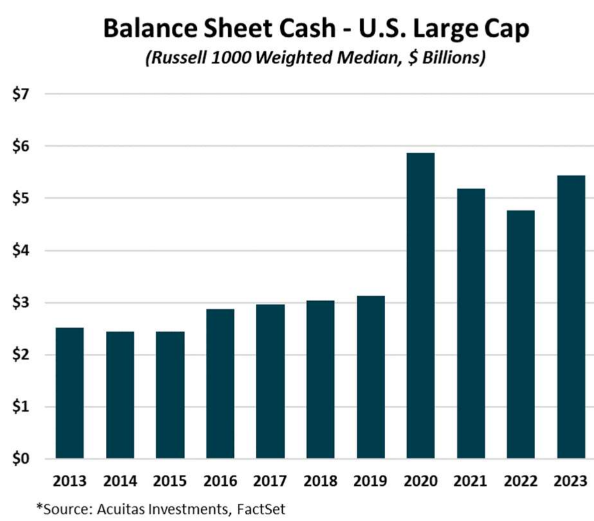
The other key point we always highlight when discussing M&A in microcap is that the premiums paid over the current market price tend to be much larger as well, which is shown in the table to the right. Once again, our managers participate in and capitalize on this tailwind, as takeouts within Acuitas' portfolios in recent years have had a median 30-day premium north of 50%. While the potential for M&A is never the sole catalyst for a manager to own a name, it is often a component of the thesis due to how undervalued many of these companies are, as well as their favorable fundamental characteristics.

Median Premium Paid (30 day)

Year	$25m - $1b	$1b - $2b	$2b - $6b	$6b +	Acuitas Composite
2019	32.9%	33.6%	28.6%	36.4%	27.8%
2020	43.6%	43.0%	43.0%	40.0%	50.6%
2021	44.2%	29.8%	29.7%	25.6%	35.4%
2022	54.5%	39.6%	37.7%	23.1%	54.6%
2023	47.6%	27.3%	28.8%	45.7%	53.7%

Source: Acuitas Investments, FactSet

Looking ahead, we feel these dynamics are quite sustainable in the current environment. Even after the fourth quarter rally, microcap valuations remain historically cheap, making them attractive targets for M&A. These attractively priced companies provide a fruitful pond to fish in for both active stock pickers and for those looking for acquisition targets. Additionally, the underlying businesses for microcap companies tend to be far simpler with fewer business units than their larger counterparts. Last, the COVID pandemic caused a meaningful shift in how companies think about and view supply chains. Many large companies now want more control over the inputs that drive their complex business and product lines. As part of this effort, they have been moving critical components of their supply chains onshore to avoid potential shipping and geopolitical issues that upended countless processes during COVID. Microcap companies are often key parts of the supply chain for larger companies, which has increased their attractiveness of being strategically acquired.



Perhaps most significant among the catalysts for microcap M&A activity is the amount of cash sitting on the sidelines. Crowding in private equity has resulted in a massive amount of dry powder that continues to sit uncommitted within private equity funds. Additionally, since the COVID pandemic a new trend of stockpiling cash has emerged: larger companies have been hoarding cash at record levels. The weighted median cash balance for the Russell 1000 Index was nearly $5.5 billion at the end of 2023, which is more than double the $2.5 billion value ten years ago.

As a recent example, Restaurant Brands International, the $35 billion parent company of Burger King, recently made a significant investment with their January 16 announcement that they were acquiring a microcap company for $1 billion. As companies look forward to a friendlier rate environment and gain more visibility on the economic landscape, we expect them to be much more aggressive at putting their cash piles to work. Microcap companies provide prime targets, and as we noted above, takeouts in microcap tend to happen at significantly higher premiums than in other areas of the market. These dynamics lead us to be optimistic that M&A will continue to be a significant source of returns for microcap portfolios.

As an additional example of the impact M&A can have, there was a unique takeout within microcap during the fourth quarter of 2023 that is worth highlighting. The largest stock within the Russell Microcap Index announced it was being acquired by the $270 billion pharmaceutical giant AbbVie on November 30. Despite being the largest company within the Index the premium paid was quite noteworthy, as the acquisition price represented a 95% premium from the prior day's close, and a premium of 120% from 30 days prior. When the largest stock in the entire Index is acquired for nearly double the prior day's market value, it is a compelling example of the inefficiencies present within microcap stocks. While incredibly unrealistic, it is amusing to come up with a parallel example for large cap: it would be the equivalent of Apple or Microsoft being acquired at a nearly $3 trillion premium above their current market cap.

For a final fun fact, at Acuitas we recently hit a notable milestone, as by our estimates we just had the 250th takeout/merger within our microcap portfolios in the last decade. Nearly 100 of these takeouts have occurred in the last three years, and there were more than a half dozen takeouts across our portfolios during the fourth quarter of 2023 despite the lackluster environment. We look forward to seeing this trend continue over the next decade.
