



FINDING MICROCAP COMPOUNDERS

A FOOL'S ERRAND OR A LABOR OF LOVE?

We have run across many different investors, potential and current, who often remark that looking for “quality” companies in the micro/nano cap space is a fool’s errand.

The issues facing us are massive: 1) little to any Free Cash Flow to reinvest 2) no staying power due to the subscale nature of operations 3) grade C if not worse management teams that are interspersed in a sea of general charlatans and do-nothings 4) illiquidity 5) a lack of overall capital market sophistication on Boards and 6) “fill in the blank generic problem of being tiny here”.

We do not argue any of these points, but instead, we embrace them as our guide to the possibilities that lie within. As is the case when generalities and stereotypes are applied en masse, the nuances and the differentiation points are painted over by the prevailing wisdom. The ability to find a “quality” company or one that will, with proper oversight and care, grow to become something that can graduate into the general small cap universe is a difficult task but Cove Street follows three basic principles/variables that are applied to everything we do and especially in micro cap: BVP (Business – Value – People).

The Businesses we look for are ones that “have a reason to exist” even if they are subscale. These are the first building blocks of any successful investment and certainly of a compounder. If the business vanishes, would anyone care? Does it earn its cost of capital? Are gross margins greater than 40% if it’s an industrial business? What is the historic track record of ROIC? Trends in operating metrics? Proper back office corporate support functions (read: ERP)? These are all generalities that strive to answer the

initial question of existence and point us to the right questions to ask management --- we want to, in the end, own businesses and not stocks. If you treat your investment as a business and not a stock, you will think about the very same things.

Value is self-explanatory but we put forth another subset of what value really represents (beyond straight valuation): catalysts of change. A traditionalist sense of value (cheapness) in our view has to be balanced by some outside force (change agent) that can close a valuation gap in micro land. This is of paramount importance since micro purgatory is a real place, filled with real companies tied up in a real malaise. These change agents are also important to avoid hitting the ever-looming plateau of value accretion in micro land. Without change agents, many micro caps wind up twisting in the proverbial wind, without a direction or any ability to compound higher. Often times these are the real pivot points of a micro investment: can this compound higher or have we met the “right size” and it should be sold (if management does not want to sell themselves). There are many instances where “quality” companies have been stuck on a value plateau due to various factors and only after a change agent enters the picture (almost exclusively new management) does the compounding engine restart.

This extrapolation of value dovetails nicely into the final variable: management. The farther down the market cap spectrum one ventures, the more

important this variable becomes. In larger, scaled companies, using Peter Lynch's maxim that we should "find a business even an idiot could run, because sooner or later an idiot probably will", management is important at "quality" businesses but not as much as the business itself. In micro land, this is the exact opposite. Compounding quality business, with a reason to exist, will be driven off a cliff to a fiery grave as soon as an idiot gets their hands on the wheel. Management's marginal impact on the probabilities of success and failure are amplified exponentially and we are acutely aware of "betting on the wrong jockey". How does one judge these people? Interrogations about investment philosophies, business plans and HR goals are a start. As are operational plans, the team next to Dear Leader must be probed. Incentive plans that are properly aligned with investors (for both C-level and the next level of troops) are a must. We are avid readers of proxies and believe in paying for performance. Micro cap land should not be a charity to executives but neither can it be a penny scrimping exercise. Everyone in the same boat rowing the same way is what we want!

Mixed together, these are the three starting building blocks for our all investments we make in microcap. The nuances and shades of grey abound, but this is the general template for how we operate. It is a labor of love, no doubt, to sift through the filings of thousands of micro companies that are public for various reasons. Nevertheless, the rewards can be large and the law of small numbers is always on our side!

Eugene Robin, CFA joined Cove Street in 2011 as a research analyst from Proton Capital, a family office where he developed investment ideas in both public and private markets. As a firm principal, Eugene shares generalist research efforts and is a Co-Portfolio Manager on our Firm's Micro cap strategy. He has also served on the Board of Directors of VerifyMe (VRME) and currently sits on the Board of Research Solutions Inc (RSSS). Eugene previously worked at ViaSat as a software engineer and holds an MBA from the UCLA Anderson School of Management and a BA in Computer Science from UC San Diego.

Eugene lists Ukrainian intrigue, craft beer evaluation, lacrosse, and corralling his two sons as his preoccupations outside the office.

For more information about Cove Street Capital, please visit: www.covestreetcapital.com



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