

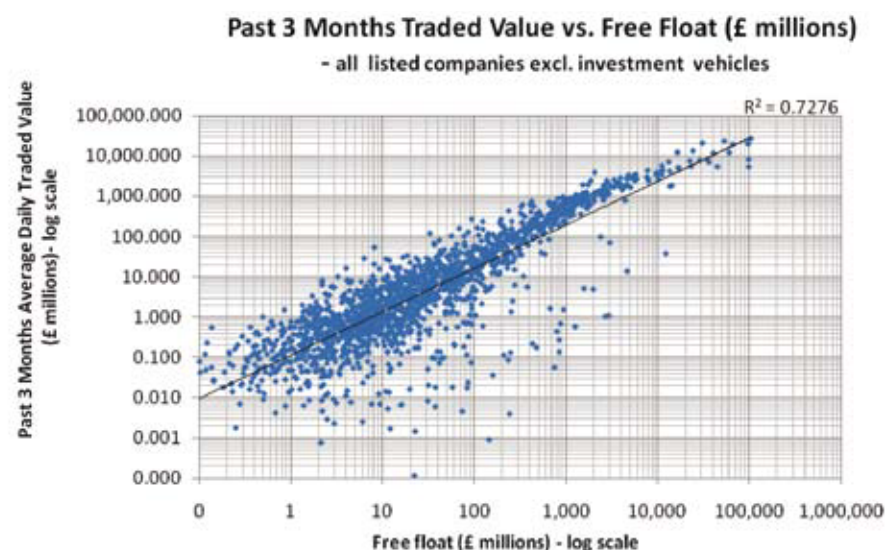
The Visibility-Liquidity-Low Share Price Dilemma for Small and Mid-Cap Stocks

Company management repeatedly complain that the market does not value them correctly

This is particularly acute among companies with a sub-£100 million market cap, who assert that their visibility among investors is insufficient to drive investment despite tremendous success in their particular sector, where in many cases they may be recognised market leaders or best-in-class operators. To optimize the value of a listing, it is essential to increase visibility in the market.

Taking a look at the FTSE small cap and AIM markets by industry sector, we begin to understand the problem.

For any investor, whether a generalist or a sector specialist, this looks to be a cluttered market, where finding an attractive investment could be as arduous as finding a needle in a haystack. There are 2,954 stocks listed on the London Stock Exchange's main market and AIM, which, when adjusted for secondary listings, trusts and other investment vehicles, leaves 1,682 companies. Each sector or subsector includes winners and losers, companies built through acquisitions or mergers, some with counter cyclical characteristics, others in turnaround mode, and many with a business as diversified as the problems they face every day. Even for professional investors, selecting the one, two, or up to five attractive investments in any given sector is already looking to be a daunting task.



Source: Bloomberg, 6 July 2009 and PSQ Analytics

Liquidity

A further obstacle is uncovered when we look at the liquidity of these companies. In principle, the bigger the market cap, the more liquid the stock, but do companies with similar market cap have significant differences in liquidity? We measure liquidity as the daily average trading value over the past three months and plot it against free float, which is considered a better measure than market cap for our purpose:

Starting from the top right, we have the super-large caps, like Royal Dutch Shell, GSK, or Vodafone, with extensive media presence, and free float in excess of £10bn. As we move down to the £1bn market cap mark, outliers start to appear in the graph, significantly below the trend line. These are companies 100 times

less liquid than comparably sized peers. Between £10-500 million free float, the dispersion between companies of similar size is striking. A significant portion of these companies are about 100 times less liquid than comparable companies (without considering the couple of dozen outliers that are more than 1,000 times less liquid; assumed to reflect corporate issues occurring during the period analysed). This dispersion becomes even more consistent for companies below £10m free float, which are usually outside the investment universe of fund managers, precisely because of their small size and lack of liquidity, and dominated by private investors. Whether you consider a specific sector, geography, or other simple criteria, the same trend is observed. What are the potential explanations for this?

	FTSE 350	FTSE Small Cap	FTSE Fledging	AIM All-Share	Non-Indexed	Total London listed
Stocks	356	268	122	979	1,229	2,954
Companies ¹	298	163	93	854	274	1,682

Source: Bloomberg, 6 July 2009

The graph below demonstrates that the availability of research helps to explain this dispersion in liquidity between companies of comparable size. We observe that companies of similar market cap (or free float) can have very different research coverage levels.

Bid-ask spread

Another comprehensive measure of liquidity is the bid-ask spreadⁱⁱ, or the ‘liquidity premium’. Stock price is generally determined by market makers, for whom the bid-ask spread is a source of profit in exchange for the liquidity risk taken. Hence, in general, the more illiquid a stock, the wider the spread.

Although a stock can fluctuate wildly in reaction to news, what concerns an investor is their overall gain/loss on a net basis, which includes actual gain/loss considering the transaction cost and bid-ask spread. While the transaction cost is fixed, the bid-ask spread is variable with liquidity. As an investor will seek to minimize the total cost, they will be attracted by stocks with minimum bid-ask spread.

What determines the bid-ask spread? The graph below shows that while the general rule holds – the higher the liquidity the less the bid-ask spread – for companies with a free float from £5-100 million (or trading from £100,000 to £100 million per day) the spread can range from 10% to upwards of 60%.

“Even for professional investors, selecting the one, two, or up to five attractive investments in any given sector is already looking to be a daunting task”

“The availability of independent research is an important factor to generate investors interest, which hopefully will lead to higher trading and would reduce the bid-offer spread of the stock over time”, according to Julian Palfreyman, CEO of Winterflood Securities, one of the largest market makers in UK. Market makers also need valid information to determine stock price. If a stock has continuity and depth in price based on a ‘fair value’ coming from a comprehensive earnings consensus, the stock appears less risky to market makers and requires less spread.

Private client brokers particularly active in the small and mid-cap space risk their clients falling into a ‘liquidity trap’ if stocks are bought only based on exciting trading news and fascinating business cases. Stocks that will prove difficult to trade are avoided by checking the bid-ask spread and ensuring the target company has a valid earnings consensus. This usually requires a minimum of between three and five analystsⁱⁱⁱ covering the company.

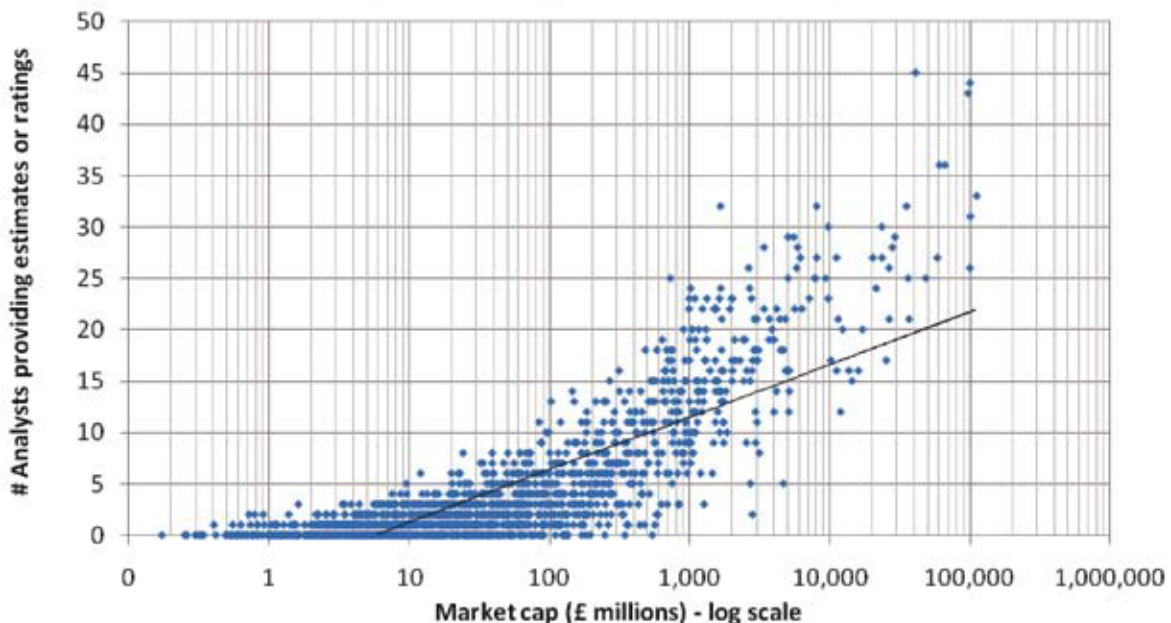
Broker economics

Based on the unbundled commission structure introduced by the FSA, the

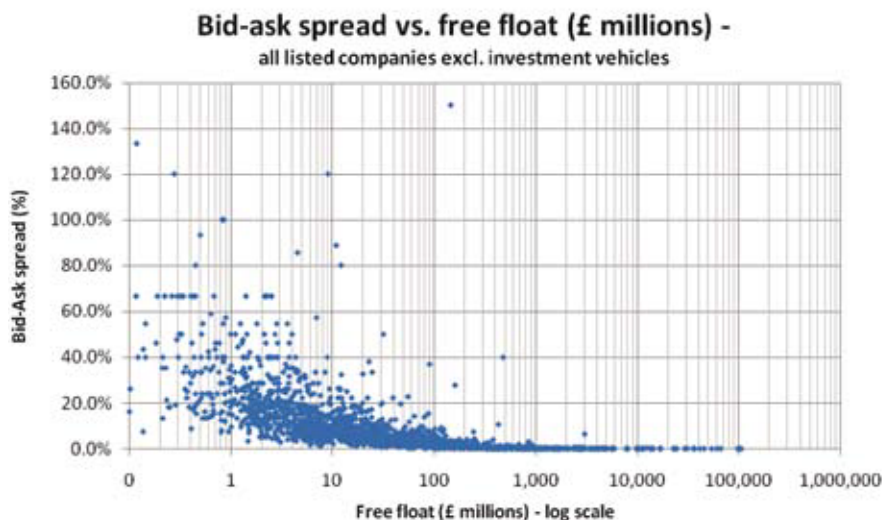
trading value chain can be simply described as follows: investment managers place a ‘buy or sell’ order to brokers, who then trade accordingly and charge commission. Commission received by brokers is then split into two parts, execution and research (plus services such as sales). Total commission figures vary across fund managers, but we assume 16 basis points^{iv} for the purposes of this report (if, for instance, a fund manager bought £10 million of Company X’s shares today, then he/she pays £16,000 total commission on this trade – £8,000 for execution and £8,000 for research).

If we view the trading value chain from a broker’s point of view, we must ask the question: “which stocks can generate commission for us?” Data suggests somewhere around £50 million per day average trading value is the starting point for many brokers in considering whether research coverage for a company for which they are not the house broker is sufficiently profitable to allocate an analyst, write research and distribute to fund managers (Note: we exclude annual corporate broker fee).

Analyst coverage vs. market cap (£ millions)



Source: Bloomberg, 6 July 2009 and PSQ Analytics



Source: Bloomberg, 6 July 2009 and PSQ Analytics

Suppose, on average, a city analyst specialising in small caps earns £150,000 per year (base plus bonus on the average year). He/she covers an average of 15 companies. Assuming that the analyst is the largest component of the research cost, each stock covered should generate at least £10,000 research commission. Therefore, the annual trading value should be at least £12.5 million, or approximately £50,000 daily average. This can be viewed as the break-even point for a broker to initiate research. For cases where there are one or two brokers already covering the company (and therefore attracting a significant portion of trades) the actual break-even point is several multiples of this figure, probably around £250,000 of daily traded value.

The reality can be very different from the illustration above, but given that there are other indirect costs involved, a company that doesn't reach that minimum level of average daily traded value has a minimal chance of being covered by a broker. This minimum threshold implies that 1,250 companies will be left out of the liquidity 'zone', essentially lacking an effective share price formation process unless a remedy is put in place.

Potential solutions

"Information is the lifeblood of efficient and transparent markets", says the website of the London Stock Exchange.

What can companies or their brokers do to resolve this dilemma? Potential solutions include efforts to raise visibility by contracting specialists in generating news and increasing media presence among investors. There are many companies, including financial PR firms,

focused on this type of service. A related option is to hire a specialist in organising investor events, where companies are able to present to audiences of professional or private investors, who are offered the opportunity to ask specific and relevant questions.

"By commissioning research, companies do not depend on broker economics or the liquidity of their stocks to increase visibility"

Another solution is for companies to commission independent equity research. By commissioning research, companies do not depend on broker economics or the liquidity of their stocks to increase visibility. In the UK market a number of companies have emerged, including Edison, Equity Development and Hardman, providing 'sponsored' or 'paid-for' research. Recently, new models – notably, 'intermediated' research – have emerged to provide company-sponsored research, in an effort to increase market efficiency. Here, a framework is established in which either an exchange or another institution 'intermediates' between the company and the research provider to ensure strict standards of independence and objectivity, addressing concerns about the impartiality of the traditional model. This is the approach supported by the London Stock Exchange with the recent launch of PSQ Analytics.

Similar solutions have been announced globally during 2009, as bourses around the world, including NYSE, Nasdaq and Singapore have become increasingly aware of the problem faced by listed companies outside the very largest market cap group.

Conclusion

There is strong evidence that a significant portion of smaller cap companies listed on the London Stock Exchange's main market and AIM are neglected by private and professional investors. This is reflected in low levels of trading activity, unattractive bid-ask spreads and in many cases, lack of investor awareness about successful underlying business cases. Broker economics prevent brokers from covering a large portion of these companies, thus preventing the companies from raising their profile, reducing spreads and increasing liquidity; all conducive to a fair share price formation. Traditional forms of company paid-for equity research, or more evolved intermediated equity research, combined with increasing media presence among relevant investors are potential remedies for companies that have fallen foul of the low liquidity-visibility trap. ■

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References:

ⁱ Companies exclude secondary listings and listed investment vehicles like ETFs, ETCs, investment trusts and others.

ⁱⁱ Bid-ask spread measured as % is the difference between the bid and offer price at any moment in time divided by the last traded share price.

ⁱⁱⁱ Further details can be found at "Analytical neglect of UK equities", John Borgars, Equity Development, 2004

^{iv} FSA reported an unbundled 8bps commission for execution, while the research portion of commission is reported to range from 0 to 22bps. Empirical evidence shows that about half of the total commission is allocated to execution and half to research therefore we have assumed in this report an average total trading commission of 16bps.