

Micro-Cap Stocks: A Surrogate to Private Equity

Executive Summary

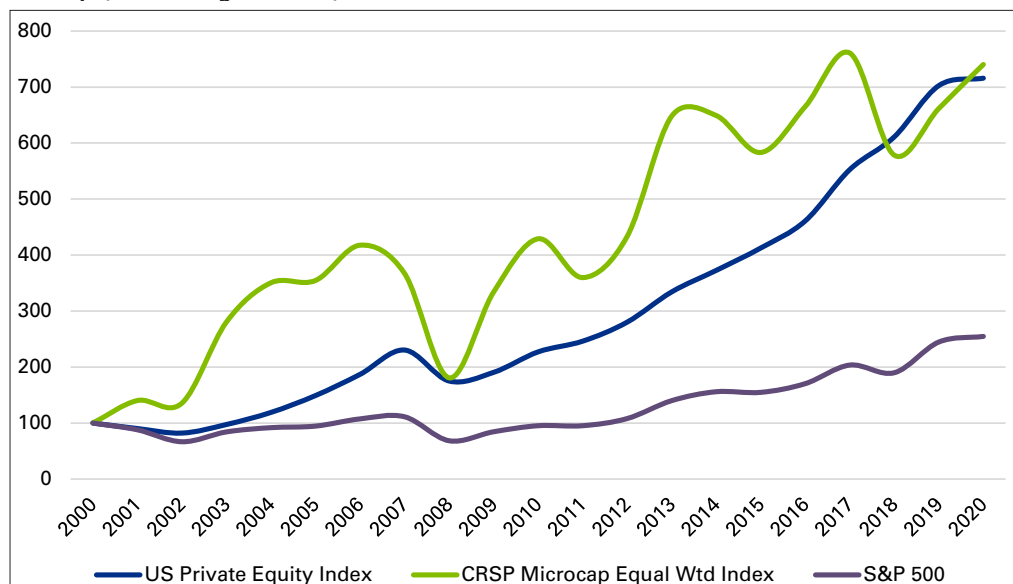
Investments in actively managed micro-cap value strategies have historically outperformed private equity (or “PE”) investments. For a number of reasons, we anticipate that publicly held micro caps will continue to offer returns that exceed those of average private equity fund investments, providing a compelling alternative for investors seeking an analogous and superior return profile with increased liquidity.

Outperformance

Historical analysis shows that over time, actively managed, value-oriented micro-cap funds tend to outperform private equity. Data from alternative-asset analytics provider Preqin, for instance, quantifies that since the start of 1995 to June of 2020, the US Private Equity Index increased by 716 percent. While that represents an attractive return on investment and exceeds the 255% percent of the S&P 500 Index during the corresponding period, the CRSP Equal Weighted Microcap Index, by comparison, grew by 740 percent. [Exhibit 1]

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Exhibit 1:
Public Equity versus Private Equity Returns
 January 1, 1995 through June 30, 2020



Data as of June 30, 2020. Source: Preqin, Fama-French CRSP Database.
 Past performance is not an indication of future results. Please refer to the disclosures on the last page for more important information.

While micro-cap stocks have outperformed private equity over varying time periods, the two categories share similar performance trends. The return profiles are not a coincidence. Active managers in micro-cap stocks target similar assets as financial sponsors in the small- and middle-market segments, seeking value-oriented investments in businesses with consistent cash flows and strong fundamentals.

Catalysts Supporting Micro-Cap Outperformance

- **Capital Flows:** With market capitalizations of \$750 million and under, the universe of micro-cap stocks we analyze consists of approximately 8,700 companies, yet the amount of institutional capital dedicated to the micro-cap category has shrunk since 2008. The private equity asset class, on the other hand, continues to attract capital faster than sponsors can deploy it, creating an imbalance that favors the inefficiencies found in the micro-cap segment.
- **Leverage:** As is implied by the term leveraged buyout, private equity firms rely on debt as a critical component of their investment thesis. As such, private equity-backed companies can carry added risk when compared to securities in the micro-cap segment, where companies generally employ a conservative capital structure. In fact, as of June 2020, Private Equity deals were averaging 6.7x debt/EBITDA (earnings before interest, taxes, depreciation and amortization), compared to the Russell Microcap® Index average of 4.3x.
- **Valuations:** The inefficiencies inherent to the micro-cap universe, due to a smaller pool of dedicated capital and neglect on the part of the analyst community, result in stock prices that often do not reflect the intrinsic value of the underlying assets or the potential for growth. Private equity funds, while they stand to benefit through active ownership, have increasingly built their portfolios through competitive auctions, a factor that reduces the value sponsors would otherwise capture at the time of their investments. The most recent data suggests the public microcap universe trades at a 35% discount to private equity transactions to private equity transactions as seen in exhibit 7.
- **Volatility Opportunity:** While stocks in the micro-cap segment are characterized by short-term price volatility, for actively managed value-oriented funds, the price movement presents a compelling opportunity to find attractive entry valuations for high-quality stocks. Moreover, the robust Merger & Acquisition activity in the segment, augmented by private equity participation, maximizes the potential for value creation.
- **Fee Structure:** As a result of these and other characteristics, micro-cap stocks can offer returns for investors in actively managed value strategies that exceed private equity fund investments, absent the inflexibility of a multi-year lockup and costly fee structure that is common to PE limited partnership arrangements.

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Capital Flows & Institutional Coverage

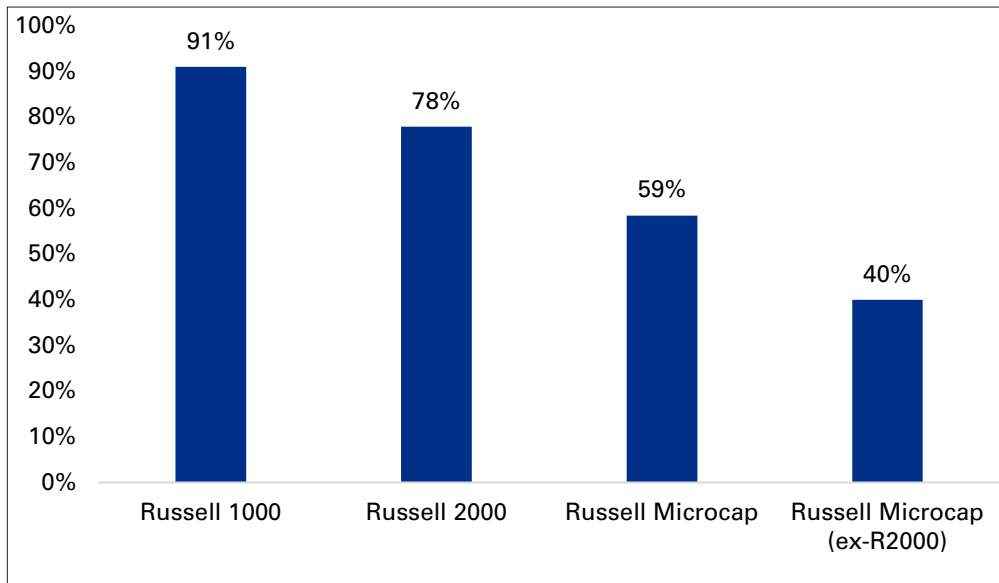
In spite of the outperformance, institutional investors often overlook micro-cap stocks.

Dedicated U.S. micro-cap stocks – those in the Russell Microcap® Index – collectively have a total market cap of about \$465 billion, made up of 1,306 companies. Surprisingly, mutual funds and institutional investors, including both active and passive strategies, hold roughly 78% of the total holdings in the Russell 2000 but only 40% of the non-Russell 2000 microcap universe.

Exhibit 2:

Median Institutional Ownership

As of December 2020



Data as of December 2020. Source: IBES, Factset, BMO.

Note: Median institutional ownership is the median percent of the amount a company's available stock owned by mutual or pension funds, insurance companies, investment firms, private foundations, endowments or other large entities that manage funds on behalf of others. Please refer to the disclosures on the last page for more important information.

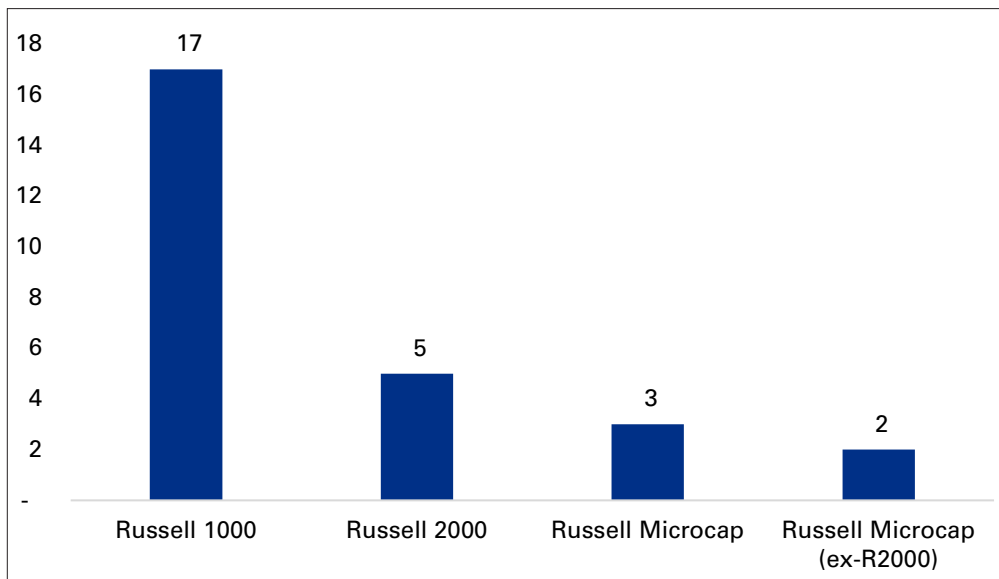
Correspondingly, the institutional analyst community, and even the media, often ignore microcap stocks, which only adds to the inefficiency of the category.

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Exhibit 3:

Median Analyst Coverage

As of December 2020



Data as of December 2020. Source: Bloomberg.

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Moreover, in just looking at the flows into public stocks versus private equity, an influx of capital has consistently moved into buyout funds over the past decade. U.S. private equity funds, for instance, have increased from \$60 billion of capital inflows in 2010, to \$316 billion in 2019, with an average nearly \$175 billion of capital inflows per year over the last decade

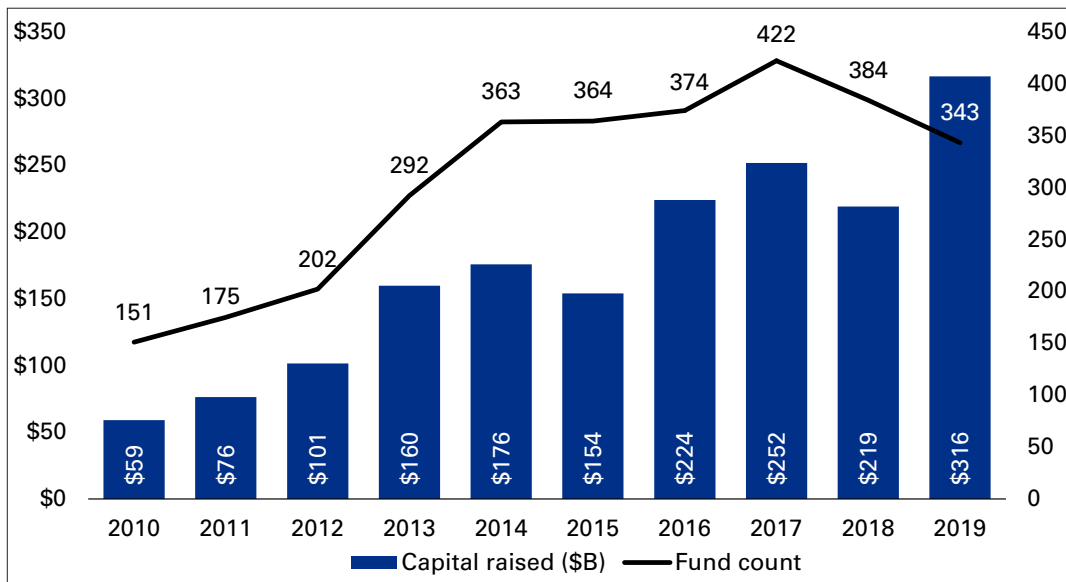
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according to Pitchbook. Consequently, according to the latest Preqin data, financial sponsors had a record \$1.5 trillion of uncalled capital, or dry powder, as of June 30th, 2020.

Exhibit 4:

Private Equity Capital Fundraised (U.S. Market)

January 31, 2010 through June 30, 2020



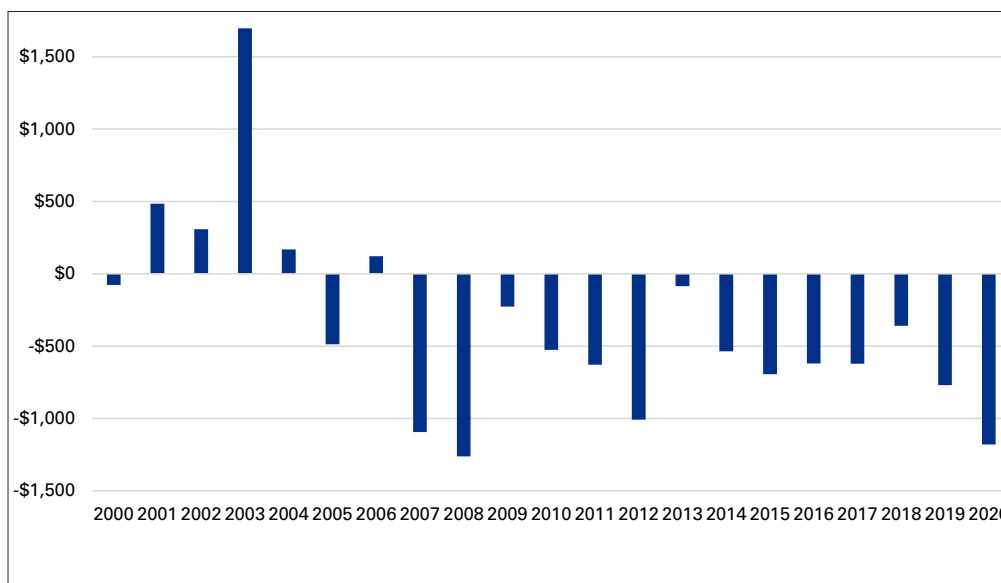
Data as of June 30, 2020. Source: Pitchbook. Please refer to the disclosures on the last page for more important information.

In stark contrast to the Private Equity industry, Microcap public equity fund flows have been persistently negative for over a decade. Despite this fact, microcap performance remains on par with private equity returns, a testament to the resiliency of the asset class. Notably, the recent introduction of zero-fee trading has created the influx of retail participation in the equity market, which can benefit active value investing fundamental strategies.

Exhibit 5:

Microcap U.S. Public Equity Net Fund Flows (\$mm)

January 1, 2000 through October 31, 2020



Data as of October 31, 2020. Source: Morningstar. Past performance is not an indication of future results. Please refer to the disclosures on the last page for more important information.

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Valuation & Leverage

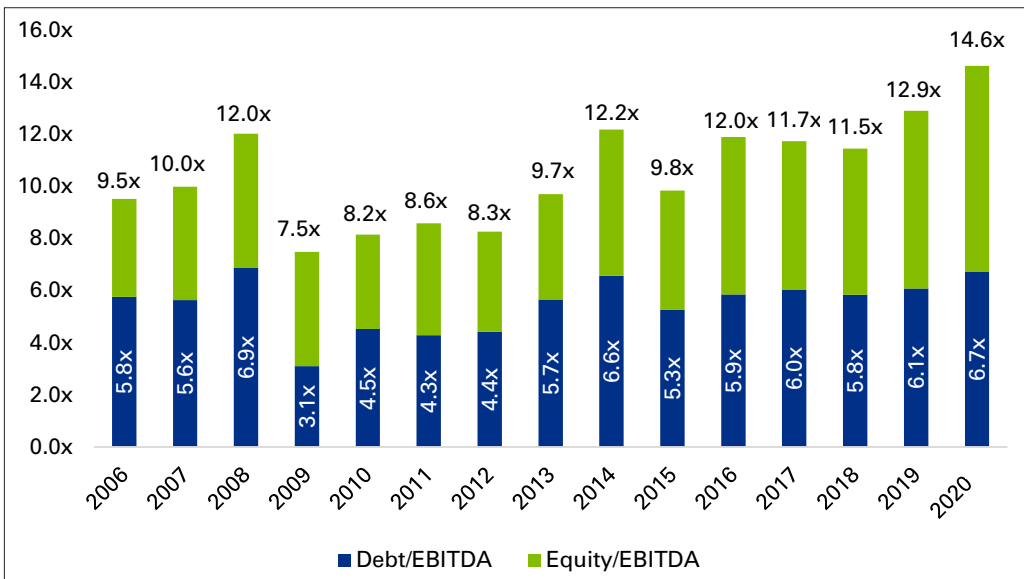
As has been well documented over the years, leverage remains a critical component to private equity's investment thesis. While leverage is often a primary driver for private equity returns, a side effect has been the steady rise in transaction multiples over the last decade, as leverage levels escalate.

As of June 2020, the average PE deal transacted at 15x EBITDA, which is 25% higher than the prior peak and nearly 50% higher than the long-term average. The record amount of dry powder and robust debt markets have conspired to push valuations ever higher for leveraged buyouts, particularly as few deals today will escape an auction, which anecdotally can attract as many as 10 or more competitive bids. Against a backdrop of high valuations, historic returns can be harder to achieve for PE sponsors facing the possibility of multiple contraction, and excessive debt loads can come at the expense of capital investments in company operations.

Exhibit 6:

U.S. Private Equity Purchase Multiples And Leverage

January 1, 2006 through June 30, 2020



Data as of June 30, 2020. Source: Pitchbook.

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With debt representing a key pillar driving private equity returns, it also introduces new risk. The Federal Reserve and Office of the Comptroller of the Currency, in 2013, went so far as to set a suggested cap of 6x EBITDA for banking institutions providing loans for leveraged buyouts. However, after staying relatively stable at roughly 6.0x from between 2013 to 2018, average debt multiples for PE transactions have risen to 6.7x EBITDA as of June 2020, a mark not seen since the last peak in 2008. Higher leverage levels may create greater volatility and more risk in private equity returns going forward.

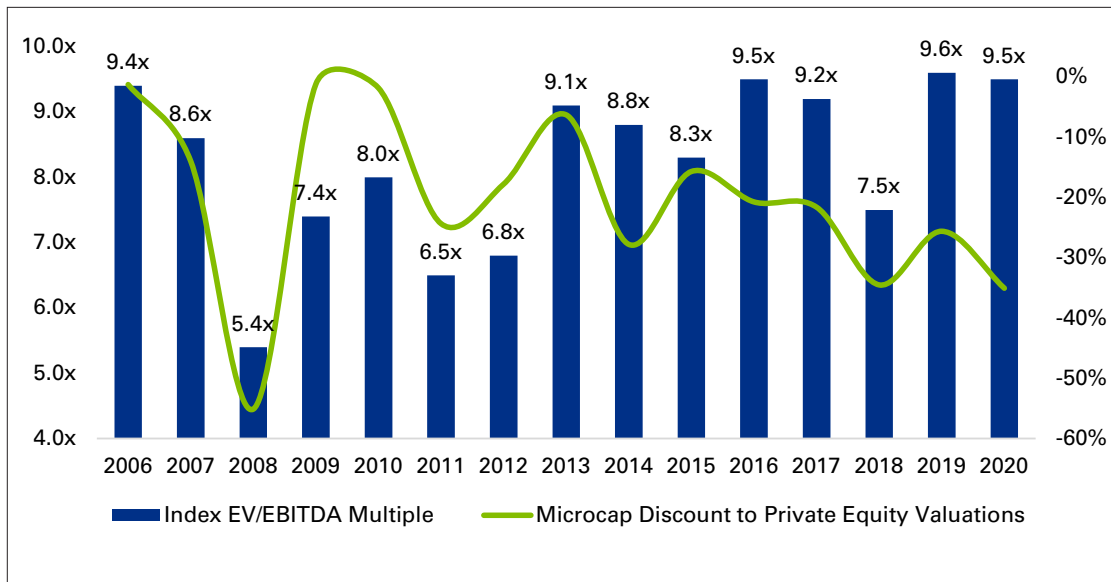
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Exhibit 7:

Russell Microcap® Enterprise Multiples And Leverage

January 1, 2006 through June 30, 2020



Data as of June 30, 2020. Source: Russell Microcap® Index, Bloomberg refined universe (blue bars). Blue and pink bars are represented by the left axis and the green line is represented by the right axis. Past performance is not an indication of future results. Please refer to the disclosures on the last page for more important information.

In contrast against this picture of unsustainable increases in private equity leverage and valuation multiples, microcap valuations are hovering around their long-term historical average with 30% lower leverage.

Buyout Opportunity In Microcaps

Micro-cap stocks have historically shown more volatility than other market-cap segments. Active, value-oriented fund managers, however, can benefit from an “information” advantage, and can alleviate the volatility through extended holding periods of high quality assets. Moreover, a certain amount of volatility has proven to be appealing, as it contributes to the low-degree of correlation with other public equities and presents more opportunities to find attractive entry prices.

The variance between private valuations and the entry prices for investors in public equities is perhaps best reflected by the average 90-day premiums of public equity takeovers. Since 2015, acquisitions of public entities show quarterly average premiums of 27% compared to the average trading price during the 90 calendar days ahead of the deal announcement. The takeover premium rose to 35% as of Q3 2020, a level not seen since Q4 2015, which presaged a 53% rise for microcaps in the subsequent three years through September 2018.

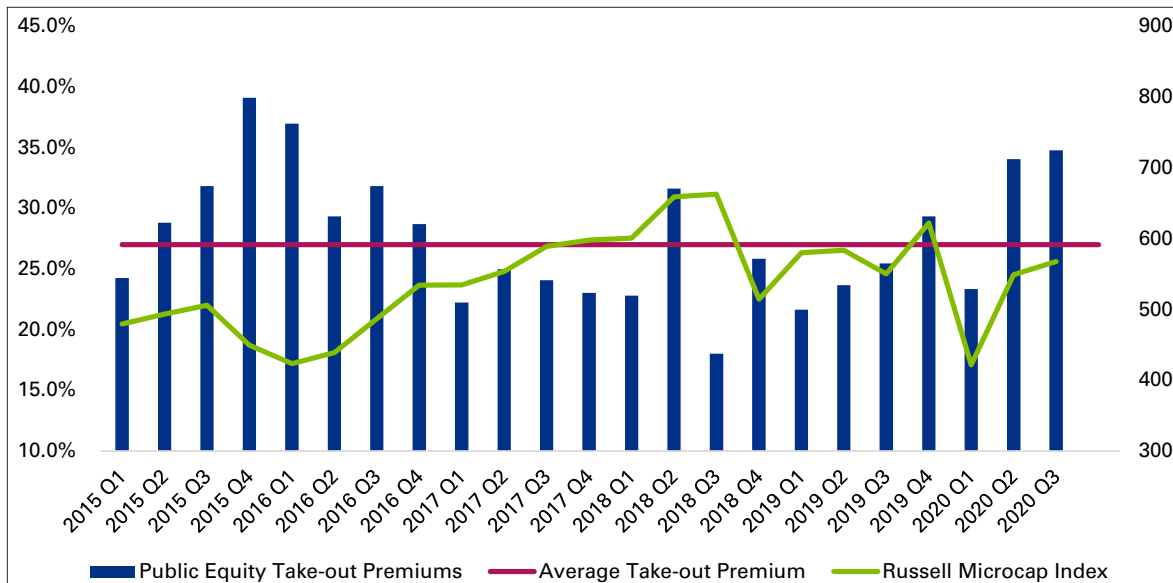
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Exhibit 8:

Public Equity Take-out Premiums versus Russell Microcap® Index Performance

January 1, 2015 through September 30, 2020



Data as of September 30, 2020. Source: Russell Microcap® Index, Bloomberg refined universe (blue bars).

Blue bars are represented by the left axis and the green line is represented by the right axis.

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Fee Structure

When compared to public equities, the private equity asset class is still marked by the inflexibility of a 10-year lockup and the costly 2% and 20% fee structure (referring to a 2% management fee on total assets and a 20% carried interest cut on proceeds from distributions to fund investors). Also, a significant portion of buyouts contain transaction fees, which typically range from 2% to 3% of the total deal size, and monitoring fees, which can come in as high as 5% as a percentage of EBITDA, according to PitchBook. Other fees and charges, such as legal costs, taxes and miscellaneous expenses, are often charged back to the funds, increasing the total cost to investors.

An April 2015 CEM Benchmarking study shined a light on the variance that exists between the reported management fees of PE investments and the actual direct costs to limited partnerships once all other charges and expenses are accounted for. Using a \$3 billion PE fund as an example, CEM Benchmarking estimated that the average difference between what funds actually report as fees and the estimated total cost to fund investors amounts to 202 basis points or \$61 million, which also serves to underscore the obscure and discordant nature of PE fees.

Conclusion

All of this is not to say that the similar return profiles of micro-cap value equities and private equity should preclude investors from considering the role of leveraged buyouts funds within their portfolios. Rather, the data suggests that for those who either cannot access top quartile private equity, or want to supplement their private asset class exposure, actively managed, value-oriented micro-cap investments can provide an attractive surrogate investment strategy. The same would also hold true for investors with allocations to PE funds who may be seeking an appropriate destination for uncalled capital, one that offers the desired alpha of private equity with the liquidity needed to quickly move in and out of investments as demanded.

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Important Disclosure Information

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Value stocks can perform differently from the market as a whole. They can remain undervalued by the market for long periods of time.

Investments in micro, small and mid-capitalization companies present a greater risk of loss than investments in large companies due to greater volatility and less liquidity.

About Boston Partners

Boston Partners is a premier provider of value equity investment strategies that are firmly rooted in fundamental research and are based on a disciplined and repeatable investment philosophy and process. Boston Partners is focused on investing in companies with attractive value characteristics, strong business fundamentals, and positive business momentum and shorting companies whose stocks exhibit value risk, earnings risk, and balance sheet risk. While rooted in fundamental research, the process is heavily aided by quantitative tools to narrow the investment universe and ensure portfolios are consistently tilted towards attractive value, quality, and momentum characteristics on the long side and the inverse on the short side. The firm, founded in 1995, has a longstanding reputation for superior client service. Boston Partners is an indirect, wholly owned subsidiary of ORIX Corporation of Japan. The WPG Small/Micro Cap Value Fund was formerly part of Weiss, Peck & Greer, which managed assets since 1970 and was acquired in 1998 by Robeco. In 2007 it was merged into Robeco’s U.S. operations, and in 2014 it became part of Boston Partners’ strategies.

About the Author

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Portfolio Manager



Mr. Gandhi is a Portfolio Manager for the WPG Partners Small and Micro Cap Value team. He joined WPG Partners in July 2012 as a research analyst with a concentration in technology, media, telecom and consumer. Prior to joining the firm, he was a member of the Applied Value Investing program at Columbia Business School. Prior to Columbia, Mr. Gandhi was an Associate in the investment banking division at Needham & Company. He graduated with a B.S. degree from the University of Maryland and received an M.B.A. from Columbia Business School. Mr. Gandhi holds the Chartered

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Definitions:

Actively Managed: a fund in which a manager or a management team makes decisions about how to invest the fund's money.

Private Equity: an alternative investment class and consists of capital that is not listed on a public exchange

Cambridge Associates U.S. Private Equity Index: Data compiled from 1,406 funds, including fully liquidated partnerships, formed between 1995 and 2018. Median returns are net of fees, expenses and carried interest.

S&P 500 Index: The Standard & Poor's 500 Index is a market-capitalization-weighted index of the 500 largest U.S. publicly traded companies

CRSP Equal-Weighted Microcap Index: Equal weighted portfolio of the smallest 10% of companies traded among the NYSE, AMEX, and NASDAQ, re-balanced every June.

Buyout Funds: A buyout fund takes money from investors and uses it to buy other companies, sometimes taking publicly traded companies private. It generally intends to improve their operations and cut costs, then resell the companies to other investors or on the public markets. Buyout funds are a type of private equity fund.

Passive Strategy: is a long-term strategy in which investors buy and hold a diversified mix of assets in an effort to match, not beat, the market.

EBITDA – Earnings Before Interest, Taxes, Depreciation, and Amortization. It is a metric used to evaluate a company's operating performance.

Debt/EBITDA: The total amount of debt on a company balance sheet, divided by their earnings before interest, taxes, depreciation and amortization.

Equity/EBITDA: The amount of equity capital used by the Private Equity firm to purchase the company, divided by their earnings before interest, taxes, depreciation and amortization.

EV/EBITDA: enterprise value divided by earnings before interest, taxes, depreciation and amortization.

Public Equity Takeover: when a publicly-traded company is purchased by another company.

Basis Point: otherwise known as bps or "bips," are a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument.

Alpha: a measure of the active return on an investment, the performance of that investment compared with a suitable market index.

Russell Microcap® Index: a measure of the performance of the microcap segment of the U.S. equity market

Russell 1000® Index: a measure of the performance of 1,000 of the top companies by market capitalization in the United States.

Russell 2000® Index: a measure of the performance of approximately the 2,000 smallest-cap American companies in the Russell 3000® Index, which is made up of 3,000 of the largest U.S. stocks.

Russell 3000 Index: a measure of the performance of 3,000 of the largest U.S. stocks.

Russell Microcap® (ex-Russell 2000): the stocks that are included in the Russell Microcap® Index that are not included in the Russell 2000® Index