

# Small Companies Pros and Cons



**Pam Lacey**

**Rocky Mountain Chapter  
Director**



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## What Is A Small Company?

- BI Definition is less than \$500 million sales
- A small company could be
  - a mid-cap company when measured by market capitalization (Market capitalization = Shares Outstanding times Share Price).
  - A large or mid-cap when measured by growth
    - **Large:** <7%
    - **Mid Caps:** 7 – 12%
    - **Small Cap:** >= 12%

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## Advantages of Small Companies

- Faster Growth
- Increased Choice
- Undiscovered companies at a good price
- Less complicated
- Niche Market
- Performance determine by own actions

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## Faster Growth

- Easier to increase sales from \$10,000 to \$20,000 than from \$1 billion to \$2 billion.

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## Increased Choice

Many more small companies than large companies

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## Undiscovered Companies at a Good Price

- Possible low valuation because funds cannot invest in them and analysts do not follow them.
  - Institutions often cannot buy large blocks of the stock due to own rules.
  - Analysts do not find it worth their while to follow stocks which institutions will not buy.

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## Less Complicated

- Often have one product
- Tend not to be diversified
- Have lower debt levels, since borrowing is more difficult for them

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## Niche Market

- Niche market – a market which has accessible customers, a need which is not being met and no competitors for the product
- May be a copyright or patent
- Ideal for a small company

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## Performance

- Performance determined by own actions not be economy as a whole
- Quick reactions to changing conditions

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## Disadvantages of Small Companies

- Volatility with greater risk
- Unfamiliar names and less information
- Increased risk of losing important customer
- Exposure to new competition
- Vulnerability to bad news
- Too rapid growth
- Inexperienced management

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## Volatility

- Less liquid than medium and large companies
  - Limited number of buyers and sellers (the stock is less liquid)
  - Bad news may make buyers scarce, causing a sudden drop in price

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## Unfamiliar Names

- Company names may be unfamiliar
- Companies may not have enough history to meet our criteria (5 years)
- Not a lot of exposure in the press
- May only have local coverage
- Will not be held by institutional investors
- Will not be followed by many analysts

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## Risk of Losing Important Customer

- May be dependent on one customer who may:
  - Internalize the operation
  - Seek a contract with a new company
  - Move to a different type of product

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## Vulnerability to Bad News

- Vulnerable to market or economic news because of low trading volume
- Vulnerable to internal bad news

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## Vulnerable to Competition

- Loss of niche position as others enter the market
- Difficulty competing with a large company that enters the field
- Dependent on one or two products

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## Growing Too Fast

- Management may be able to manage a small-scale operations, but not an expanding operation
- Many managers of small companies may be original owners or developers of the products
- They may not have the management skills for an expanding operation

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## Lack of Management Experience

- Management may have no experience in developing continuity in management
- May be dependent on original managers rather than bringing in experienced outside managers

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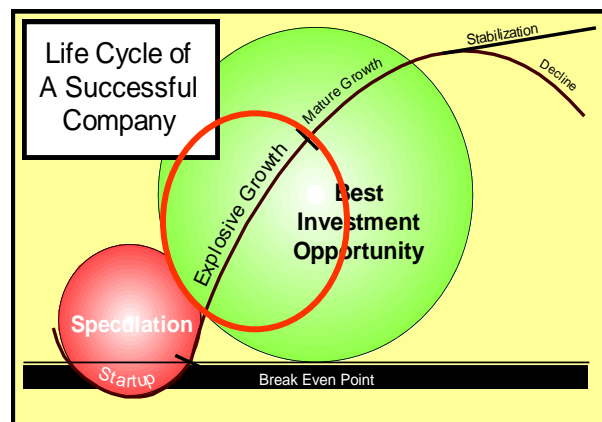
## How Can We Minimize Our Risk?

### Follow BetterInvesting Guidelines

- 5-Years of history
- Consistent growth
- Good management

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What Should We Look For: Try to find a company when it is in its explosive growth period.



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## What Else Should We Look For?

- Strong balance sheet
- No debt
- Growth
- Niche – little competition
- Availability of information
- Understandable product

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## Avoid:

- Turnarounds
- Too rapid growth
- Insider ownership less than 15%
- Companies with no earnings
- Companies that do not have a unique product or wide moat
- Over-priced small companies – look at the PE (BI looks for  $\leq 30$ )

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## Let's Recap

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Perhaps we should consider this  
proverb:

*From small beginnings come great things*

Can we afford not to be there?

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materials**



**and introduce others to this opportunity.**

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