

Picking Small Cap Winners

Seven guidelines to help determine which small companies will be successful and which will fail.

BY BRYAN A. TANNENBAUM

Let's say you've been approached by the proverbial "kids-in-a-garage," who have come up with a brilliant idea. They now have about a dozen programmers on staff, some working on the premises and the others in their homes. The company, which we'll call Twokids.com, has a culture that runs 24 by 7, fuelled by Jolt Cola and Doritos.

The two kids seem to have what it takes—technical skills, intelligence and enthusiasm to burn. What they don't have to burn is money, and this is why they've dressed up in their idea of business attire, and are sitting in your office.

You've been under some pressure to increase your portfolio's investment in startups, owner-operated businesses and small caps, and this company looks like a good possibility. Certainly worth a good hard look.

The problem is that Twokids.com would scare off any traditional, pin-striped banker. No receivables, no assets, not much industry experience. Just some people with a dream.

In fact, they're not much different from any startup in any industry; the usual measures, based on historical data, are sketchy at best. This is far from investing in established corporations, who are able to call up investment relations advisors and which are scrutinized by professional analysts using published financial figures. Smaller companies present investors with a whole new set of challenges.

What are this company's odds of succeeding and of your success if you invest or advise others to do so?

Not great. For every business success story there are many companies that quietly burn through their money and disappear.

However, there are some common factors that indicate a likelihood of success and separate the winners from the losers. Certain characteristics are needed to make a company, including one as leading-edge as Twokids.com, thrive.

THE CORPORATE CHECKUP

In dealing with the high risks associated with emerging businesses, the following kind of diagnostic review is essential.

* Strategic planning – Examine the organization, structure, goals and objectives, including the proposed management of the stages of business growth, and identify the critical factors important to the success of the business. These are unique to each situation.

Consider factors such as the structure and legal setup of the organization, its organization chart, policy manual, and the duties of executives. Examine the lines of authority and responsibility to see if these are enough to keep the work flowing smoothly. In operations, look at its standard operating procedures and planning procedures. For an external look, examine the company's place in its industry, the markets it serves, its short- and long-range prospects, and geographic factors. Look at its prospects for continued growth.

* Sources and adequacy of capital – Study both debt and equity, and question if these are sufficient to do

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the job. If not, are there realistic prospects for capital infusions (including your own planned investment) that will make the picture more attractive?

3 * Cash and working capital management – The review should find out if working capital is adequate for business demands, and if cash management will ensure that daily requirements are met. Determine if forecasting is realistic and adheres to how the organization deals with variances between actual and budgeted results. How are the relations with existing lenders in areas such as revolving lines of credit? Is the company keeping its bankers up to date on its development so that there are no unpleasant surprises?

4 * Marketing and sales – There must be an adequate market plan and product planning, with product pricing that suits the market. Plans for promoting the product and distributing it must be appropriate and adequate. The company must have a system in place for monitoring competition and industry trends.

5 * Effective production and inventory management – Even a dot.com must meet its deliverables and must keep some kind of inventory in stock. This drives a need for planning and control in this area. Quality control, financial controls and facilities must be able to do the job.

6 * Human resources – Skilled, experienced management with a proven track record of success is often the key factor for any company, much more important than any technology or business idea. If the vision of the management team is to come true, it is important to pay attention to staff recruitment methods, hiring decisions, training, and compensation and benefits. Staff must be motivated through sharing the company dream or philosophy, and reviews must be held to evaluate the effectiveness of each staff member. Communication between management and staff, and among staff members, is important. In your review, consider staff planning and utilization, the laws and regulations pertaining to the business (such as environmental regulations), any contracts with any unions, and steps taken to maintain the health of the workforce.

7 * Management information, controls and reporting – Examine the general ledger system, the procedures for producing financial statements and other management reports, and how well this information is used for making decisions. There may be areas in need of special

review that pertain to the specific industry.

This list may look daunting, but it is essential to put together a picture of the company, its risks, and how it is facing those risks. The chances of making a wise investment decision can be significantly improved with this sort of analysis.

IF TROUBLE OCCURS

An important leadership skill is being able to manage change. Business leaders are faced with organizational crises on a daily basis—and for many managers it is the loudest, most urgent-seeming crises that preoccupy their time. Only a few managers are taking advantage of the opportunities posed by crises. The difference between danger and opportunity lies in the way those managers think about change, and the way they manage change in everyday activities.

Those that fail to manage change may well find their dream gradually slipping away. One day they may find out that they are in an insolvency situation. Often this comes as a complete surprise even to people closely involved with the company. This is both unfortunate and unnecessary.

In almost all cases, there are signs of pending business failure that were clear for those with the ability to read them. Stakeholders, such as investors, are in a good position to protect themselves from the consequences of business failure, and even from preventing the failure from occurring. A diagnostic checkup, such as that outlined above, may help point out “red flags” that signal danger ahead, and allow the company to take preventive action.

However, even if the company is in severe financial difficulties, there are avenues of reorganization and restructuring that can bring a company through a temporary period of difficulty and back on the road to health.

Sound investment policy consists of doing one's homework ahead of time, and this applies to startups and other small companies as much as it does to the corporate giants. However, a wise investor also knows when it is worthwhile to stay with an investment that is performing poorly, when it is important to step in and help protect that investment, and when it may be necessary to exit the relationship.

Good understanding of what makes a healthy company goes a long way to making good investment decisions. ♦