IR BEST PRACTICES:
MEETING THE MICROCAP CHALLENGE

Every great company was once a microcap company. Equally, for every great company there are thousands that were microcap companies that failed to achieve greatness. This is the essence of the challenge for the microcap company. Every banker, lawyer, accountant, potential employee and investor would rush to the future great company today, probably work for free, probably invest a great deal, however they also want to avoid being associated with the next failure.

How does a microcap company convince the world at large that there is a good chance that they will be great?

Compelling investment thesis
Engaged investor following
Superb investor communication
Access to new capital
Higher valuation
Greater stock liquidity

PERFORM INVESTOR RELATIONS LIKE A GREAT COMPANY - BE CLEAR, CONSISTENT, CREDIBLE AND COMPLIANT (the 4Cs)

Financial theory tells us this kind of behavior makes sense. If the manager of a business knows more about the business than a potential investor then the investor will demand a discount to compensate for the risk that he is being sold a "lemon.[1]" That discount can be reduced by disclosure of more and more timely information that is clear, consistent and credible. As the discount falls, the price of the stock rises and the company's cost of capital is reduced.

Why then do we say "perform IR like a great company?" Why is there so much more to it than defining what we mean by "disclosure" and then making it consistent, compliant, clear and credible? Especially when extensive disclosure is required by the SEC in its rules for the issuance of financial results on forms 10-Q and 10-K, and the disclosure of material events on Form 8-K. This certainly leads some managers to ask the question "if I comply with disclosure under the SEC rules, especially the more stringent rules enacted under Sarbanes-Oxley, what benefit is there to additional disclosure?"

Like it or not, today's investors demand greater transparency and access to management than just the opportunity to plough through mandatory SEC disclosures. Providing more information about operations, financial performance, future plans and corporate governance can build credibility and trust. Some of the most successful companies in the world embrace broad transparency of their strategy, targets, milestones,

COMPASS IR worked extensively to set up the IR strategy for a REIT that, initially was the smallest of its quoted peers.

"I just want to congratulate you on the quality and depth of the disclosure in your press release. I think you are setting a new standard for your peer group."
--JMP Securities Analyst, on the Company's Earnings Conference Call

Subsequently the company has tripled its market capitalization, attracted 11 analysts and other forward-looking information. Therefore provide investors and other stakeholders with the information they need to make informed decisions about whether you are going to be a great company. Academic research supports the idea that greater transparency can lead to lower transaction costs and greater liquidity[2]. Especially in periods of high volatility, a lack of transparency and poor investor relations practices have been shown to be play a major role in large decreases in shareholder value.[3]

Action item: Establish best practices in investor relations and disclosure. Consult with key advisors, including an IR consulting firm, accounting firm and outside legal counsel, with regard to communicating the performance and prospects of your company to all of your stakeholders.

ATTRACT TALENT AND KEEP GREAT COMPANY

It is well-known that those who provide resources to young companies, when faced with uncertainty, which clearly includes lack of experience with the companies themselves, "triangulate" or, as the authors of one study put it "rely on the prominence of the affiliates of those companies to make judgments about their quality."[4] Research also suggests that when "triangulators" find that firms are already keeping good company, they are more inclined to get on board themselves.[5] Many companies understand this concept and know that investors will go to great lengths to triangulate when contemplating an investment. The best microcap companies do some of this legwork proactively, making it clear who already endorses their business (bankers, board members, accounting firm, employees, VC backers, etc). Anyone still in doubt about this idea can see it demonstrated every day by companies looking for customers without the benefit of a well-recognized brand. Restaurants promote their head chefs and the big brand restaurants they have worked at in the past. Independent filmmakers promote the track records of their stars and directors.[6]

COMPASS IR worked with an early-stage Biotech company to prepare a triangulation plan. The messaging was crafted and targeted at a customized audience of ~600 Key Opinion Leaders, investors, bankers, analysts and commentators in the specialist therapeutic area. The company has attracted a major strategic investor and has a ready-made audience for updates on its progress, enhancing the prospects for attracting new partners and capital

Action item: Formulate a triangulation plan that incorporates networking among your key triangulation points and facilitates communication through the right messaging and the use of conventional and new media.

TARGET INVESTORS STRATEGICALLY

Successful microcap companies eventually become small-cap or even large-cap companies. They accomplish this by building and running successful businesses while being strategic about their capital markets strategy. Identifying and targeting the most appropriate investors for your story at each stage of your development as a public company is a critical element of this process.

First and foremost, be honest. Understand what you are. If you are a newly-public former LBO with 4X leverage, start with investors who have tolerance for that kind of capital structure. Next, identify the natural investors and specific funds with investment styles that are aligned with your company's story. From there, identify each fund's holdings and obtain its investment criteria. Traveling to Boston on a wet Wednesday in January to be told five minutes into the first meeting, "let me stop you there, we don't invest in pre-revenue biotech" is extremely frustrating. There are plenty of occasions where a clearer analysis of the targeted funds and a description of your investment thesis ahead of time produced five good meetings rather than three good ones and two where your presentation was a nice try but was never going to interest the audience.

Action item: Consult with advisors including your investor relations firm and investment bank about your capital markets strategy and optimum shareholder constituency as you evolve as a public company.

START CONVERSATIONS

Existing Investors - your best investor is an existing investor. Someone who now owns your stock should be embraced. Find out why they bought and ask what it would take for them to buy more. What will cause them to hold longer and what will cause them to sell. For a microcap company executing on this idea requires some creativity. Keep track of your investors who reveal themselves in any forum. Perhaps some hold your shares in their own name as opposed to street name. Make sure your website has a place to sign up to receive company updates and press releases. Take business cards at trade and investor conferences. Encourage dialog on your website, in a company blog and through your Facebook and LinkedIn presence.

Small Hedge Funds - Investors who tolerate high risk and, let's say, an "evolving" investment thesis are a valuable constituency for many a microcap. That said they require high (and therefore quick) returns on their investments. Small hedge funds are often run on a high risk/high return strategy and may be the best "early adopters" of your stock. Keep in mind, once their price target is reached they will sell. So, be sure to court future relationships with more patient and conservative investors to replace the early adopters when the time comes.

High Net Worth and Family Offices - There are as many different types of non-institutional buyers as there are retail shoppers. For the microcap company, you want investors who are prepared to accept the risk and return mix that your stock offers today. Seek to minimize spurious volatility in your stock that you can't influence and that is driven by non-credible communication and puts your long-term reputation at risk. You can successfully target the retail market by seeking high net worth investors or family offices who professionally manage money. Retail investors who are essentially

COMPASS IR worked with a microcap that was clearly unloved and under-appreciated. It communicated by "fluffy" press releases, and uninspiring quarterly releases and calls. We reached out to over 350 investors and found that the company's news covered every aspect of its business except the ones that were important to investors.
We recommended a revised investment thesis and a new communications plan incorporating relevant information and forward-looking statements. This was targeted at a custom-made audience of ~400 institutions, and, from an initial target list of over 525 names, we developed a group of more than 100 newly-engaged investors ready to follow the company's story

gamblers day-trading on meaningless press releases, rumors appearing on twitter or elsewhere on the web are unavoidable but certainly are not to be actively courted.

Overseas Shareholders - The capital markets are becoming increasingly competitive and more global. It may make sense for a microcap company to broaden its outreach beyond the US. Certain countries have investment cultures that could be viable audiences for your company. Weigh this against any investment you have to make in communicating with investors in foreign domiciles and make sure the pool of capital you are targeting justifies the expense.

Long-term Institutional Shareholders - Shareholders who plan to hold your stock long enough to really understand your investment thesis and to understand your communications about changes in market dynamics and your strategic initiatives are valuable. However, keep in mind that the mandates of many large, long-term institutional investors prohibit investments in microcap companies.

Sell-side Analysts – While microcap companies are too small for most sell-side analysts to follow, they can be valuable resources to them. The better sell-side analysts are industry experts, and it is part of their mandate to be aware of all of the players in the space, large or small, and how they may influence the companies that they follow. So, if your company has a technology, product or service that could potentially disrupt the business of a Fortune 500 company in their coverage universe, the analyst following that company will want to talk to you. This could lead to including information about your company in future research reports issued by a very credible source.

Compass IR worked with a microcap that had tried everything – paid-for research; specialist roadshow organizers (there was not a fund in the Boston-New York corridor that had not been pitched multiple times); stock promoters rewarded with "free" stock, all had delivered less than they had promised. We re-evaluated their investment thesis, reached out to the right audiences across the US and Europe. We found 25 funds who wanted to meet them and 6 sell-side analysts who wanted to hear the story.

Strategic Investors –Large credible shareholders such as venture capitalists (VC's), LBO shops and serial Angel investors can be very valuable because they are a ready-made triangulation point. On the flip side, many microcap companies fear these investors because once they exit their positions, the company may have a hard time attracting new capital. While this may be a genuine concern, it really depends on the reason the strategic investor is selling. It is common knowledge that investors like VCs need high IRRs. Since IRRs tend to decay rapidly with time, few are surprised if they start to lighten their position. However, if the VC's sell every time the stock rallies and the stock does not recover quickly, investors will become wary. If the VCs sell, and the stock rebounds quickly, no one worries. In the same way, if you need to sell new shares to raise more money to grow the business, it is a positive signal if existing investors seed the new financing. Although no one expects the "A" round investors to participate in a secondary once the company is public.

Senior Management and the Board - It clearly adds credibility for these insiders to hold a stake in the company. In fact, the corporate governance policies of some of the best public requirements require minimum investment thresholds for insiders. The street closely monitors the buying and selling behavior of insiders. So, if shares are sold outside a 10b5-1 plan and the company then performs badly, or if shares received in an option plan are sold, particularly after the strike prices of the option awards are falling or have been re-priced downward, expect investors to head for the exit.

Action item: Engage an experienced IR firm to take your story to the right target shareholders.

INFLUENCING INVESTOR PERCEPTION

Once you start conversations, you will receive feedback about how your stock and company are perceived in the marketplace and the strengths and weaknesses of your positioning relative to other alternatives. Some microcap companies attempt to overcome negative feedback by telling the same story louder, thinking that the investors didn't hear it right the first, or even the second time. The best microcap companies listen carefully, develop communication strategies and modify their messaging to address investor concerns or objections.

Action item: Proactively influence investor perception by taking feedback seriously. An outside investor relations agency can play a critical role in delivering unbiased feedback to microcap companies.

MEETING THE ILLIQUIDITY CHALLENGE

First of all, why should a company care about the liquidity of its stock? After all, the shares have been sold and the cash is in the bank. Stockholders might complain that they cannot sell their shares easily or cannot sell them without moving the price against them but, so what? Well, those shareholders may be your best targets for your next capital raise. If they are concerned about the risks of owning illiquid shares they may not buy more. They may sell the shares they have now or may demand higher returns (in other words lower share prices) to buy more. Equally, potential new shareholders will revise downward their target buying price, putting pressure on the market for the stock and lowering the price. The corollary of the lower price is a higher cost of capital, and the consequent negative impact on growth and the ability to compete.

Other illiquidity challenges? The most obvious is large movements in the stock price when shares are bought or sold. This is a significant potential problem for microcap companies with very large blocks of shares held by individual shareholders, strategic partners or small institutions. Other elements of illiquidity cost[7] include liquidity that falls if the stock price falls and wider bid-ask spreads for illiquid stocks. So, how do microcap companies help bridge the illiquidity challenge?

Float, Ownership and Capital Structure – As a microcap company, you may have a limited supply of freely trading shares ("float") or a large overhang of warrants or convertible debt that are limiting the liquidity or valuation of the stock. In our experience, these issues take time to resolve and involve ongoing outreach, excellent execution on the business plan by management and thoughtful decisions about future financings and capital structure. Be wary of those offering a quick and easy solution, such as internet or social media schemes, to instantly drive trading volumes. Such schemes are short-lived, if they are even successful in the first place.

Make Information Easy to Gather - Investors are short of time, and despite craving corporate information, they do not always put in the time to collect or analyze it. Therefore, in addition to performing investor relations like a great company, make information readily accessible to investors. Encourage two-way conversations so that information can be discussed and future disclosure can be enhanced.

Use Triangulation to Enhance Credibility - Triangulation adds to the flow of information beyond the channels adopted by the company itself. It is therefore critical to foster a dialog among third parties, provide links and contacts and be part of these conversations when appropriate.

	The Compass Investor Relations – Effectiveness Rankings
Rank	Action
1a	Evaluate investment thesis using investor outreach and perception mapping; enhance thesis messaging based on feedback
1b	Target investors with affinity for thesis, engage in conversation
2	Map out strategy, set milestones for investors and update engaged investors on progress regularly
3	Create triangulation plan amongst investors, analysts, KOLs and media
4	Ensure messaging consistency across all communication platforms (website, filings, presentations, calls, press releases etc.) to all parties
5	Attend large conferences hoping to meet investors
6	Use bankers or consultants to generate investor meetings
7	Seed brokerages with tradable shares to improve liquidity
8	Attend for pay conferences hoping to meet investors
9	Buy paid-for research and distribute to investor databases
10	Mass outreach to general audiences via press release, social media or money shows

Think Broadly about "Analyst" and "Shareholder" - While keeping the quality of "the company you keep" high, recognize that the right journalist, key opinion leader, blogger or small but articulate and well-respected shareholder is the "early adopter" who increases liquidity and share price long before Fidelity takes an interest. The resulting increase in investor and analyst following and the widening and deepening of the shareholder base will improve liquidity and enhance share price and volume.

Action item: Focus on the long-term liquidity of the company and work with key advisors to develop the best communications platform, outreach program and capital markets strategy to get there.

CONCLUSION

For the microcap company there are no simple rules. However many companies will benefit from formulating tactics that incorporate these ideas:

- Perform investor relations like a great company
- Keep the best company possible
- Embrace triangulation
- Ensure your story is being told to the right audience
- Start conversations and be a willing participant.
- Utilize feedback to proactively influence market sentiment
- Prioritize scarce capital and management resources for cost-effective IR

<u>Work with a strategic investor relations consultant to formulate an investor relations and communications strategy that maximizes your chances of obtaining scarce resources in competitive markets</u>.

About Compass Investor Relations

Compass Investor Relations is a specialist investor relations consulting firm. We are proud to partner with more than a dozen public companies in the U.S. and China today and to have worked alongside many more on special projects. Our four partners have combined 40 years of investor relations expertise, specializing in strategic consulting, financial analysis and communications, market intelligence, investor outreach and marketing. With scalable engagements, customized solutions and industry expertise, the firm is dedicated to helping our clients build long-term, sustainable shareholder value. For more information about our services visit www.compassinvestorrelations.com.

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[1]See the classic paper: "The Market for Lemons: Quality Uncertainty and the Market Mechanism" (1970) by George Akerlof, Quarterly Journal of Economics.

[2]"Transparency, Liquidity, and Valuation: International Evidence on When Transparency Matters Most." (2012) by LANG, M., LINS, K. V. and MAFFETT, M., Journal of Accounting Research.

[3]"Risks that Matter" (2002) by Oxford Metrica and Ernst & Young.

[4]Interorganizational Endorsements and the Performance of Entrepreneurial Ventures, Stuart, Hoang and Hybels, Administrative Science Quarterly, Vol. 44, No. 2 (Jun., 1999)

[5]In the Stuart study they find "young companies "endorsed" by prominent exchange partners will perform better than otherwise comparable ventures that lack prominent associates. Results of an empirical examination of the rate of initial public offering (IPO) and the market capitalization at lP0 of the members of a large sample of venture-capital-backed biotechnology firms show that privately held biotech firms with prominent strategic alliance partners and organizational equity investors go to lP0 faster and earn greater valuations at lP0 than firms that lack such connections. They also empirically demonstrate that much of the benefit of having prominent affiliates stems from the transfer of status that is an inherent byproduct of interorganizational associations.'

[6]Getting known by the company you keep: publicizing the qualifications and former associations of skilled employees, Roberts and Khaire, Industrial and Corporate Change, 2008.

[7]In fact each of these sources stem from things like trade processing costs, asymmetric information between buyers and sellers; costs of search for (credible) information about the stock, inability to go long as well as short of a stock, costs of liquidating a stock at the very time the market is systemically losing liquidity. See, among others, "Large investors and liquidity: a review of the literature" by Matthew Pritsker.