THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Finding Growth Opportunities in Micro-cap Stocks

NANCY PRIAL, CFA, is Co-Chief Executive Officer and Senior Portfolio Manager at Essex Investment Management Company, LLC. She is the portfolio manager for the micro, small and smid growth strategies, leading an all-women investment team. Earlier, she worked at Burridge Growth Partners as the Chief Investment Officer and Senior Vice President responsible for the smid and small-cap growth strategies. The Essex Small Cap Growth Strategy was launched and developed by Ms. Prial in 2001 while at Burridge. Previously, she worked for four years as a senior vice president and senior portfolio manager at American Century Investors where her responsibilities included leading the team that managed the Heritage Fund. She began her career at Frontier Capital Management where she was both a fundamental analyst and portfolio manager in the small and midcap area. She received a degree in electrical engineering and mathematics from Bucknell University and an MBA from Harvard Business School. Ms. Prial is a trustee at Bucknell and is the Chair of the finance committee. She is also on the executive board of the Evanston Art Center.

SECTOR — GENERAL INVESTING

TWST: Could you tell me a little bit about the company?

Ms. Prial: We are a boutique investment management firm focusing on growth stock investing. We have roughly $620 million in assets under management as of the end of 2018, spread amongst a number of strategies. But all of our strategies focus on the early identification of growth, wherever that growth is occurring within our investable universe. And we really specialize in identifying these growth trends early, before, we believe, that the general investing public has recognized the full power of the growth embedded in the company's prospects.

TWST: I understand that you have an interest too in the micro-cap marketplace. Do you want to talk a little bit about that?

Ms. Prial: The bulk of the work that I do is focused on the small and the micro-cap marketplace. We have two lead products in that area, one of which is a small-cap product that invests from roughly $75 million up to $2.5 billion, so encompassing quite a bit of the micro-cap market, as well as a good chunk of the small-cap market. And then, we have a version of the product that is a pure micro-cap product that invests in companies with market caps of less than $500 million at time of purchase.

And one of the reasons that we are excited about that part of the market — and why we use these micro-cap names not only in our pure micro-cap products but also in our small-cap product — is that we believe that this is a part of the market that is incredibly inefficient. And it's a part of the market where those inefficiencies have sustained over time and still persist even with the advent of many of the newer technologies such as artificial intelligence, quantitative trading, algorithmic trading, etc.

The reason that these inefficiencies persist is that many of the companies in this micro-cap marketplace — and again, defining micro-cap as companies with market caps under $500 million — share the characteristics of being misunderstood, very poorly known, lightly followed both by sellside analysts as well as lightly owned by buy-side analysts. And therefore, there's an opportunity to add value through the process of discovery and the research process by identifying companies that are early in a process of improving their growth prospects, and then by owning the stock both as the companies deliver on their improved results as well as, as these companies get rediscovered or discovered for the first time by other investors and, therefore, get re-rated as that process of discovery continues.

TWST: Are there some particular reasons now with the market the way it's been, the volatility, that a micro-cap or small-cap might be particularly interesting for investors to look at?

Ms. Prial: Yes. We think both small and micro-cap is an interesting part of the market to be in, but we really think that the opportunity today in micro-cap is quite, quite compelling. Part of that is the fact that the micro-cap stocks have underperformed their small-cap brethren really since 2013. And so we've had now five years of fairly significant underperformance by micro-cap, within a market where small-cap frankly has done pretty well. And so we think that that's something that's likely to reverse.

Some of the reasons why that might reverse relate to the structure of the market that we're seeing. For the last number of years, investors have really been focused on companies at the upper end of the market cap spectrum, whether that is within the small-cap benchmarks or overall in the market. And there's been a little bit of a philosophy of a winner-take-all type of world, where it's been perceived that only those companies that are the market share leaders and that have already proven themselves as superior growth opportunities are the ones that are going to reap all of the rewards.

We've seen these periods before in the past; most recently, I would say that the closest analogy would be in the late 1999 to 2000 time period. And what we know from these periods in the past is that, that psychology can change, and then, as investors start to recognize that, even though these market share leaders may continue to do quite well, that there are very compelling growth opportunities for those companies that are smaller and perhaps scrappier that are going from a very small market share to a still perhaps small market share but a much bigger market share for them.

Some of the statistics that we looked at make us think that right now is a fruitful time to be thinking about that. And in particular, when you look at the difference in valuations between the small-cap and the large-cap indices, they are the widest that they have been since the early 2000s. So what I'm looking at is price to sales and price to cash flows comparing the Russell 2000 to the Russell 1000. And again, what we've seen is that in the fourth quarter of 2018, that gap reached the widest level since the early 2000s.

Similarly, we see something with growth versus value stocks. And the difference in valuation between growth versus value is exactly the same point that it would have been in late 1999/early 2000, and the other period that it looks most like would have been in the late 1970s, both of which are periods when there was, again, this philosophy that only the largest market share leaders were the companies that you really needed to own and were the best opportunities for growth, and everything else got left by the wayside.

We're starting to see that change in the marketplace. We're starting to see that change in terms of investor behavior. In particular, what we're starting to see is some switching from ETFs to individual stock purchases. And we're starting to see that change in terms of the valuation and the way these stocks are beginning to act.

And so we are very encouraged that not only do we have a secular opportunity within these micro-cap stocks but that, in today's world, we also have a cyclical opportunity. I'll follow up my analogy from both of those periods that I talked about by remarking that those were the beginning of a five- or six-year period of significant outperformance both by value stocks but also by the smallest of the small-cap stocks. So we are cautiously optimistic that we may see a repeat of those patterns.

TWST: When investors look at small-cap stocks, are there particular things that they should keep their eyes on within the category because they are on the smaller side?

Ms. Prial: I think investors need to be prepared that, because of the lower liquidity that is embedded in these small and micro-cap stocks, that there might be more volatility around the returns than you would see within the small-caps or certainly within mid- or large-cap stocks. Particularly, on an individual stock level, there might be a lot of variability within a day or within a week or within a month or within a quarter of the way these stocks behave.

However, what I think is important for investors to understand is that volatility is not, in fact, the same thing as risk. Even though these stocks may be more volatile, they are not inherently more risky than it would be investing in larger-cap companies. In fact, at some level, one could argue that in many cases, because not only are these smaller-cap stocks, but they tend to be smaller companies that are focused on one particular business line, that they may have somewhat more control over their own destiny because it doesn't take as much revenue growth or as much revenue in terms of absolute dollars to move the needle.

Even in an economy that might be slowing a little bit, these companies can still show sales growth because they're not as dependent on GDP growth. They're really dependent on their own product development. They're dependent on their management team, hiring the right salespeople. They're dependent on being able to gain market share within a stable or growing industry.

There are many ways to approach these micro-cap and small-cap stocks. We approach it from a growth point of view, where we want to find companies whose growth rates are improving, based on catalyst and reasons that are, again, reasonably within a management team's control. So whether it's improving their balance sheet, improving their financial statement, improving their product development, rationalizing their product's footprint, increasing their sales and marketing exposure, developing new products or innovative new marketplaces, those are the kinds of reasons that we are looking for to get invested in stocks. But there are other approaches that could be more of a value-type approach or more of a GARP-type approach that also can work within this marketplace.

TWST: In some cases, from what I understand, some of the small-caps — and maybe it applies also to the micro-caps — their markets could be largely within the United States, and they may not be as vulnerable to the issues like tariffs as some of the larger corporations are. Is that something you've also seen?

Ms. Prial: It really varies by industry. So I wouldn't want to make a blanket statement and say that these companies will be less impacted by tariffs or less impacted by trade skirmishes around the world. As an investor, you need to pick your spots carefully and

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Highlights

Nancy Prial discusses Essex Investment Management Company, LLC. Ms. Prial specializes in the early identification of growth, before the general investing public has recognized a company's embedded growth. She focuses on small-cap and microcap companies because she believes that part of the market is incredibly inefficient. Because these companies are often misunderstood and poorly known, Ms. Prial is able to add value through discovering and researching them. Currently, she thinks microcaps offer a compelling opportunity. Despite investors' concerns of a possible recession, Ms. Prial believes there will be positive growth through 2019.

Companies discussed: Identiv (NASDAQ:INVE); Tecogen (NASDAQ:TGEN) and Thermo Fisher Scientific (NYSE:TMO).

understand your company's exposure. But again, the idea behind many of these companies is that if you're a $100 million- or $200 million- or $300 million-a-year revenue company, and you develop a new product, and you add $50 million or $60 million over a couple of years with that new product, that can be a pretty compelling growth rate. On the other hand, if you're a multibillion-dollar company, that same $50 million increment is just not going to have as meaningful an impact on either the top or the bottom line.

So it really comes down to the fact that it takes a smaller increment to drive very attractive growth coupled with the inefficiencies that we talked about earlier in this marketplace or as these companies are coming out with these new products or expanding into new markets or gaining share within their markets, it may not have entered investors' attention yet because these companies are not as well-followed by the Street. So they can start improving their financials and improving their business prospects, while they are still being reasonably ignored by the Street and by other growth investors, which gives, again, an opportunity to add value by identifying these growth trends very early, before those future growth prospects are fully discounted in the price of the stock. And we believe it's that combination of growth with attractive valuation that can lead to a very attractive opportunity set.

of the limelight of the public market and then eventually bring these companies back public again, after they've demonstrated what their growth potential truly is.

TWST: Changing direction a little bit, did you want to highlight a stock that you find interesting now?

Ms. Prial: I will. As I said, these are companies that can be reasonably in control of their own destiny, where a new product or a new area can really change the trajectory of the growth company, but many times, that improvement in their business is not yet fully recognized in the price of a stock. I'm going to talk about a really micro-cap name here; it's called **Identiv Inc.** (NASDAQ:INVE), about an $80 million-market-cap, California-based company, so it's a U.S.-based company.

They are in the business of physical access control. Think of it as physical access control into an office or a lab or a building, as well as identity management. They've gone from being a predominantly hardware-based solution of things like keycards and identification cards to get into a facility that needs to be secured into a business that is much more focused on recurring revenue and the software piece of identity management. They have recently signed a couple of new contracts within the banking industry that are service-based deals, which expands,

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1-Year Daily Chart of Tecogen

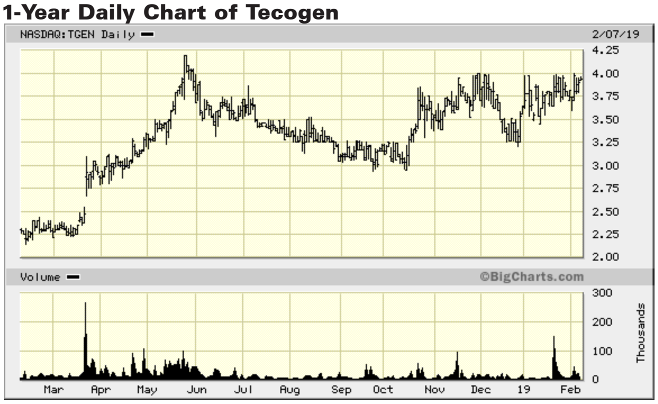


Chart provided by www.BigCharts.com

TWST: For some of them, too, I would think that sometimes they are targets for acquisitions by larger companies, which is something that investors like to watch for. Is that the case?

Ms. Prial: That certainly can be the case. There are a number of potential buyers for these companies. Sometimes our holdings get acquired by a larger competitor, who either likes the product or is trying to expand into a new product area. Sometimes they get acquired or do a merger essentially of equals, where they're both trying to build their footprint so that they have a bigger base from which to grow their companies.

But it's also a very attractive acquisition target for a number of private equity firms. We actually see a number of these firms being acquired by midmarket private equity firms, who recognize the same combination of growth and valuation that we've recognized within the public companies and see an opportunity to do some of these repairs out

again, their software and recurring revenue base, and that provides them with secure identification for bank branch security, video identification, fraud detection and ATM skimming detection.

We think that this is a company that is really well-positioned in what we know is a big need and, unfortunately, a big growth trend because of all of the fraud and cybercrime that is occurring. But they're able to get into this business. They got in both through internal development as well as through acquisition. They're able to make these inroads while the stock is still, we believe, significantly underappreciated with an enterprise value to revenue of less than one-time sales.

TWST: So it's an interesting time for investors to consider this sector?

Ms. Prial: We think so. We own some larger-cap stocks in related areas, which have been recognized and which would sell at multiples of the revenue base. We think that this one because it's so micro-cap and unknown, and the liquidity is lower than it would be with a larger cap company, that it could present a very interesting opportunity.

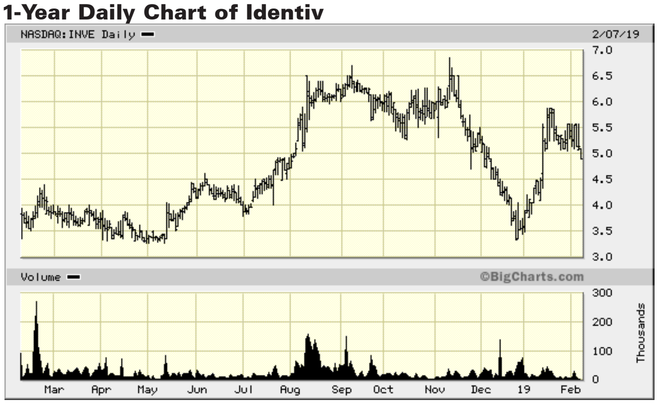
TWST: Did you want to mention another company?

Ms. Prial: I will mention one more micro-cap name that we think is particularly interesting right now. This one is a $95 million market cap, so again, very micro-cap. It's a company called **Tecogen** (NASDAQ:TGEN), based in Massachusetts, so again a U.S.-based company. They've actually been around for a very long time.

They basically sell co-generation and chiller products. Their core business has really been focused on chillers, one of the big applications for these industrial chillers and other kinds of refrigeration has actually been into the university marketplace, colleges and universities where, because of all of the devices that are being used all over the campuses, as well as the development of a number of science centers and a number of universities with very up-to-date labs, as well as retrofitting that is being done on a number of buildings so that they're appropriately cooled, that there are a number of universities that are replacing and expanding the chillers. That's been their core business.

The company, I mentioned, is very old. They were founded in the 1960s. They were part of **Thermo Fisher** (NYSE:TMO) back when it was Thermo Electron and then was spun off as an independent standalone company. And we think that, that phenomena of spinoffs is something that can be a very interesting way to invest within these micro-cap stocks, because as these companies get spun off, their original holders need to sell them because they're too small, and then, there is this opportunity for them to improve their business again while they're still being neglected and not fully recognized in the price of the stock.

1-Year Daily Chart of Identiv



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Tecogen has a very nice core base business as I talked about. The sizzle on the stock is that there is a new application for these chillers, and they're being used within the burgeoning legal marijuana market. They are selling their chillers into marijuana-growing facilities, into indoor marijuana-growing facilities. They recently sold two into a facility in Massachusetts. With the expansion of both the recreational as well as the medical legal marijuana market, we think that **Tecogen** has an opportunity to get recognized as, if you will, the picks-and-shovels supplier into what is perceived to be a very exciting growth opportunity for the U.S. economy for the next number of years.

TWST: We talked about the market. What's on the minds, do you think, of a lot of the investors you talk to right now, especially after the correction that we saw in December? Are there certain things that they're thinking about as they look at 2019?

Ms. Prial: In general, I think what investors are very concerned about is what economic growth is going to look like going forward, and particularly, are we looking at a slowdown, are we looking at sustained growth, or are we in fact looking at a recession? I would remind people that we've had calls for recession, I think, almost every year since 2010. It is now 2019, and although we've had some growth slowdowns in that period and some rolling recessions within individual industries, as we know, this is really the longest expansion on record in some time. We believe that investors are overly discounting the risks of a recession here. But that is really what investors are concerned about.

One of the reasons why we are confident that investors are overly concerned about the risks of recession is looking at the valuations that we can find in the marketplace. This is true both on the micro-cap side as well as on the larger-cap side. But I'll just point out that on our micro-cap portfolio, looking at this year's estimated earnings — we're looking at consensus earnings for this number, not our own estimates. So if we look at fiscal 2019 estimated earnings, the portfolio is selling at less than 16 times earnings. That is a very low number for a growth portfolio with the kind of growth that we have embedded within this portfolio. Generally, our portfolio would sell at between 19 times and 20 times current-year earnings.

We think that the market is really overly discounting the risks of this economic slowdown that we're seeing. In the fourth quarter of 2018, we had a number of stocks within the portfolio with a p/e ratio on fiscal 2019 earnings — dropped to less 10 times. I will caution that, and in most cases, we think that the earnings estimates for those companies are too high, and that's partially why the multiple appears to be so low. But what we know from history is that when multiples get that low with companies that are showing good cash flow, that are showing good revenue growth, that are generally solidly profitable and that are not just cyclical commodity businesses, that is a very attractive time to get invested in those stocks. But again, they were overly discounting any negative news that might be out there.

We still continue to worry about what is going to happen with trade. We're worried about, will the government shutdown again? Although, I think not. And we're worried about other geopolitical risks. But as we look at the very least U.S. economic growth, we still see that we will have positive growth somewhat slower than we had last year, but positive growth through this year. And again, as the market recognizes that, that is an opportunity for stocks to respond positively as they report their revenue and earnings.

TWST: In this kind of climate, why might it make sense for investors to turn to boutique companies instead of some of the larger investment firms?

Ms. Prial: Well, we think that there is a benefit to a firm that is incredibly focused on doing essentially one thing and focused on trying to do that one thing as well as they possibly can. In our case, we are a boutique, as I said earlier, that is focused on identifying growth early, identifying that growth wherever it occurs within our investable universe and identifying that growth at a point in time when those future growth prospects are not yet fully reflected in the price of the stock. Because we do that every day and we've been doing that for over 40 years, we have built an experiential base and an experiential knowledge that we believe gives us an opportunity to continue to be able to do that in a way that can deliver the kinds of returns that our clients would expect of us.

And we think that's a benefit to the focus that you get with a boutique where this is all we do every day. Large firms can certainly be very good, but they tend to be much more diverse, much more dispersed. I liken it really to the companies that we invest in. We would rather invest in a company that's focused on one business area, one business line, one core product area than a conglomerate that has three or four different businesses.

What we tend to find with a conglomerate with those disparate businesses is that although one area could be doing very well, it's going to get offset by weakness in another area. Whereas those companies that are focused really on that one more narrow area put all of their energy, all of their intellectual property, all the work they do behind doing the best job they possibly can to grow their business and do the right thing, in this case, for their customers in that business area. And we think that's equally true in the investing world.

We also think that this is potentially the beginning of a very good time for active versus passive. Not that passive will go away and not that passive won't continue to play a big part in people's portfolios as it provides a very cost-effective way to get broad equity market exposure, but investors are starting to realize that there's an opportunity to add some extra alpha by using active managers selectively in those areas of the marketplace where it's possible to add value because they are less efficient parts of the marketplace. We've seen that in some data in 2018; we've seen that in data that's continuing into the beginning of 2019. We're hoping that, combined with the valuations that we see, could lead to this multiyear cycle.

TWST: Is there anything we didn't talk about you care to bring up, either about the firm or some trends out there?

Ms. Prial: One trend I would like to bring up that I neglected to mention, specifically about the small-cap and the micro-cap part of the market. One of the issues that we think has been plaguing small-cap and micro-cap stocks is that the number of companies within that universe has been shrinking. That has led to the average market caps within the Russell 2000 Growth going up, because in order to get the 2,000 smallest company, it needs to go higher into this midcap part of the marketplace. It's been because of a decrease in both company formation as well as a decrease in the number of companies that are becoming public. We have started to see that change.

We saw a rebound in 2017. We saw further growth in 2018 in terms of the number of IPOs priced on U.S. exchanges and as well as in the number of the billions of dollars raised. Early indications are, with the number of companies on deck that are looking to potentially come public in 2019, that 2019 should also be a better year. That increase in the number of companies we think could be a very important factor in bringing both attention back to the smaller-cap sectors in the market as well as providing an even larger opportunity set for investors to choose from.

In addition, the recent regulatory changes that have happened over the last couple of years should make new business formation easier. It's too early yet to have any data to see if that's really true. But we are getting at least anecdotal evidence, particularly if you look at what's going on in some of the technology areas, that in fact we're starting to see an increase in the number of company formations that would also lead to a positive cycle for small-cap and micro-cap stocks. So that's another factor that we think makes the timing particularly good to be looking at this sector of the market.

TWST: Thank you. (ES)

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