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Good News: Small and Micro-Cap Stock Picking is Back – and There Will Be Big Winners

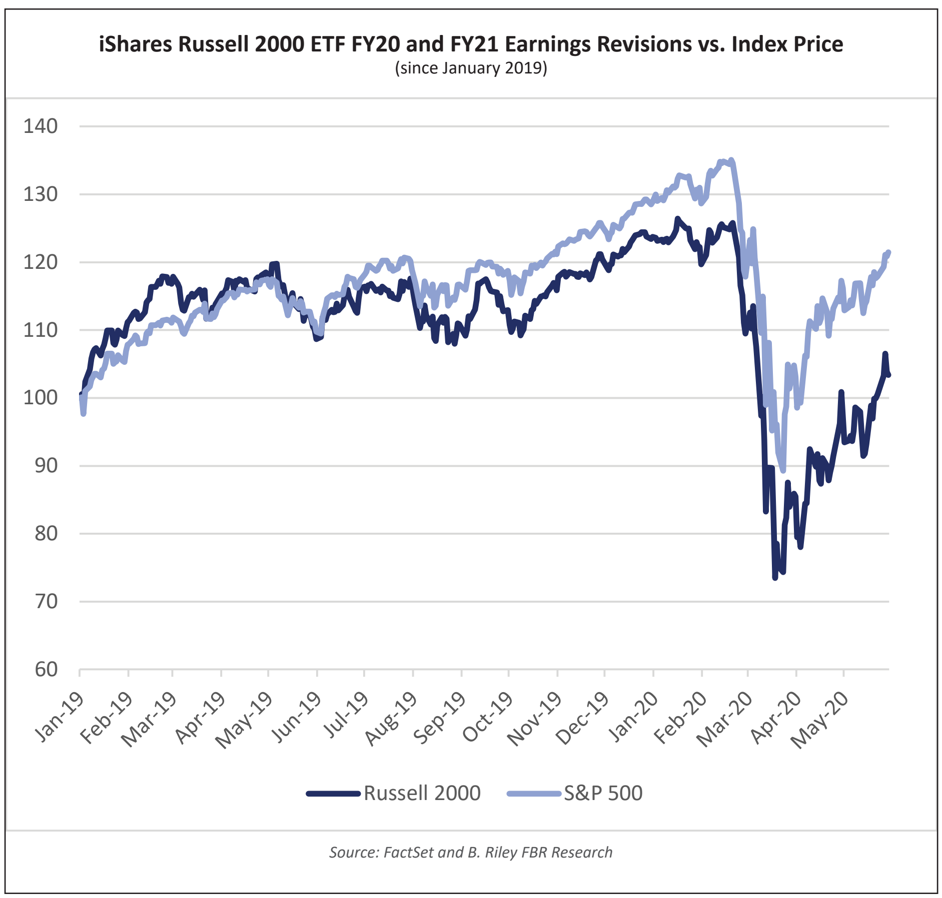
Navigating Small Cap Value Opportunities as COVID-19 Recovery Clashes with Economic Reality

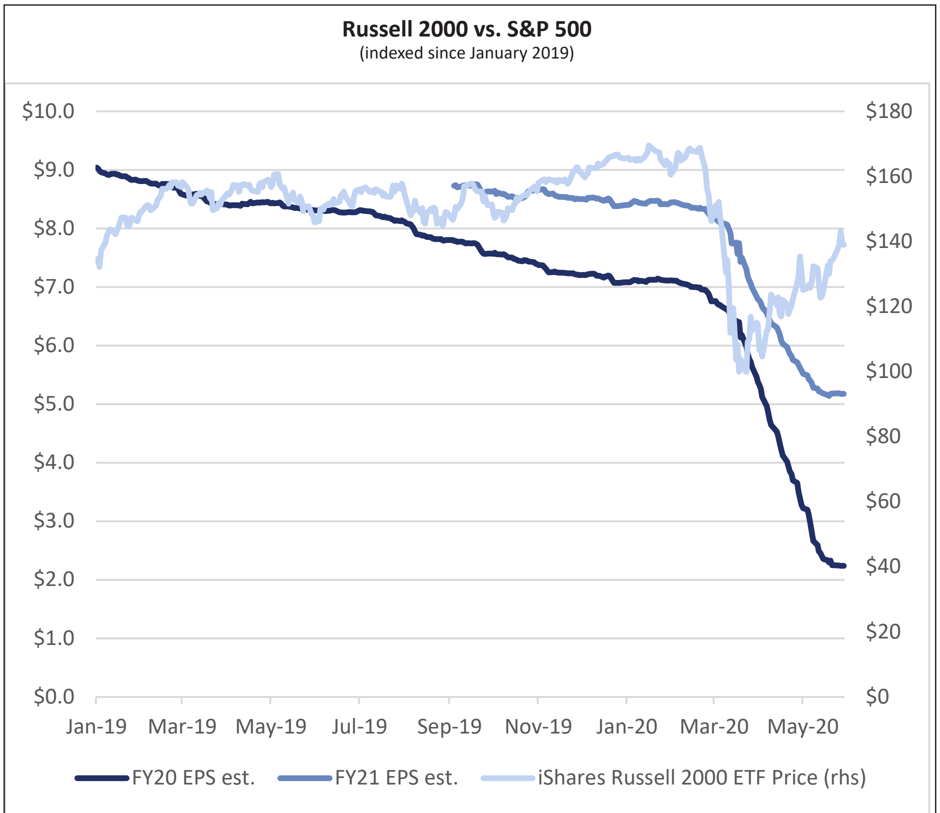
The COVID-19 crisis has created a historical level of small-cap stock underperformance relative to the broader market. Underperformance of the Russell 2000 has become more pronounced as big tech drives broad market returns, thus creating an increasingly attractive market for small and micro stock pickers.

History shows us that small-cap names tend to outperform in the early stages of market recoveries, and with the Russell 2000 outperformance in April and May 2020, there is a silver lining for certain small-cap winners as we look ahead.

The shoe hasn't quite dropped for small-cap company earnings yet. This means the current environment will inevitably create some losers too. Market sentiment has been heavily weighted toward a V-shaped recovery. The day-to-day reality is that investors

Randy Binner, MBA

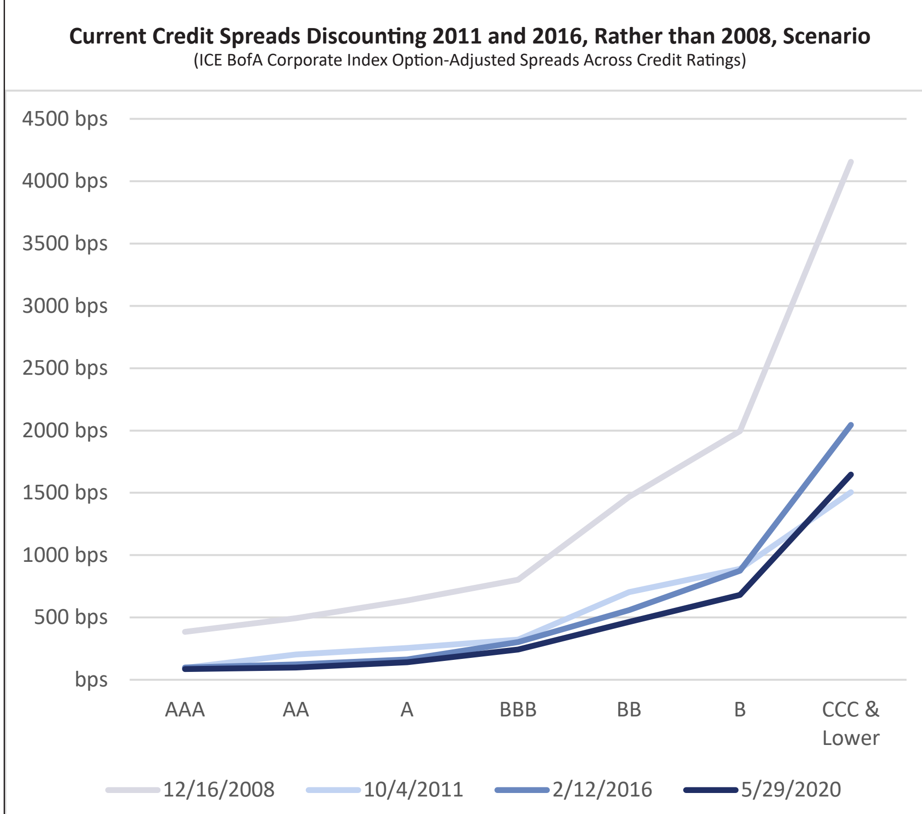




Source: FactSet and B. Riley FBR Research

seem increasingly de-sensitized to bad economic and healthcare news and are focusing heavily on state-level re-opening procedures and overall sentiment surrounding an economic recovery – but this is a risky hand-off. Stock selection must consider defensive and relative risk-reward profiles carefully.

COVID-19 related sentiment may be driving the market, but investors should be careful in using this data to price stocks. Earnings remain a reliable indicator of equity valuations – and EPS is moving lower for both the S&P 500 and Russell 2000. We estimate a 2021E price-to-earnings ratio (P/E) of 19.9x and 26.1x for the S&P 500 and IWM (iShares Russell 2000 ETF), respectively, which is historically expensive. Year-to-date, S&P 500 and small-cap (IWM) stocks have seen FY2020 EPS estimates revised downwards by 29% and 75%, respectively. Since mid-March, small-cap equities have partially rebounded with the broader market, despite additional downward earnings revisions.



Source: St. Louis Federal Reserve and B. Riley FBR research

SELECT POST-COVID WINNERS

No sector is immune. Recoveries will vary dramatically.

Retail survivors will pick up share. At B. Riley Financial, our perspective on the impact to the retail and consumer sector is firsthand. Our Great American Group affiliate, which specializes in retail liquidations and asset valuation, participated in over 3,900 store closings and several retail rehabilitation projects in 2019. We expect significant closings and bankruptcies on the other side of COVID-19. We believe certain publicly traded companies with access to capital and liquidity will emerge in a landscape where many private small business competitors do not survive. This should enable large market share gains, better access and cost around real estate.

Chicos FAS, Inc. (CHS) is a well-established missy retailer that screens well in our liquidity analysis with >20x annual interest coverage and estimated liquidity of ~$300

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million, which equates to the ability to keep stores closed for another 15+ weeks.

MarineMax, Inc. (HZO) is a recreational boat dealer that appears to be picking up market share. Boat sales are inflecting positive for summer 2020 as boating is a social distancing friendly, and family activity.

Financials sector companies' credit risk for this cycle may not be over. Investors should be selective on balance sheet risk and favor yield. Credit spreads are now well inside of 2011 European debt crisis and the 2016 energy market swings – and a world away from 2008 levels. The Fed has been *the* support for the credit market rally, but this type of intervention leaves open the risk of another move out in spreads, which would be accompanied by another leg down in smaller cap credit sensitive names.

BayCom Corp (BCML) is a Bay-area bank with an attractive core deposit franchise (34% non-interest bearing) and valuation at 7.2x our 2020E EPS, a 35% discount to peers. While the near-term credit outlook remains challenging for all banks, we see good risk adjusted upside here and with a strong capital base, management is buying back the stock.

Global Medical REIT, Inc. (GMRE) While many REITs have suspended dividends, we see the 8.4% dividend yield as sustainable, given the relatively defensive profile of healthcare properties.

Jernigan Capital, Inc. (JCAP) is a defensive self-storage REIT with a strong liquidity position. Occupancy is up over 6% year-to-date, and we believe counter-cyclical drivers of demand will continue to drive lease up. There is currently a 7.5% dividend yield based on the current stock price.

Select Healthcare names are set to grow revenue in the post-COVID era. Post COVID-19, we believe that U.S consumers will likely be more aware than ever of the need for health coverage and advanced medical technologies.

OptimizeRx Corporation (OPRX) is a digital health messaging company providing virtual solutions for the life science industry. While COVID-19 is impacting/disrupting the industry, OPRX is benefiting from the industry's immediate need to migrate to virtual solutions with management noting during its 1Q20 call that it experienced an RFP close rate of 52%.

CytoSorbents Corporation (CTSO) is a medical technology company that recently announced that it obtained a label expansion for CytoSorb (CS). CS has been gaining traction as a treatment in critically ill COVID-19 patients; and, thus, the company has materially increased its manufacturing output in recent weeks.

As always, time and the horizon ahead will be key. For institutional investors, there is considerable risk of allocating capital at the wrong time in 2020 for 2020 returns, and possibly for 2021. For investors with a 2022 and beyond the horizon, life is easier. We have laid out names here that we see as thematic winners in a post COVID-19 environment that have favorable risk reward around the potential risks of the transition from healthcare recovery to economic reality in the market.

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About the Author: Randy Binner is Group Head of Financials and Real Estate equity research at B. Riley FBR. Binner joined the firm's research team in 2004 and has covered life, health, property/casualty, and mortgage insurers, as well as asset management, REIT, and fintech companies. Prior to joining the firm, he worked at Travelers Insurance Company managing litigated claims. He earned an M.B.A. in finance from George Washington University and his B.A. in history from Colorado College.

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This piece was prepared on July 20, 2020 and our commentary is based on stock prices and estimates as of that date. For up-to-date disclosures relating to any of the stocks mentioned, please visit: www.brileyfbr.com/disclosures.

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