PACIFIC RIDGE
CAPITAL PARTNERS, LLC

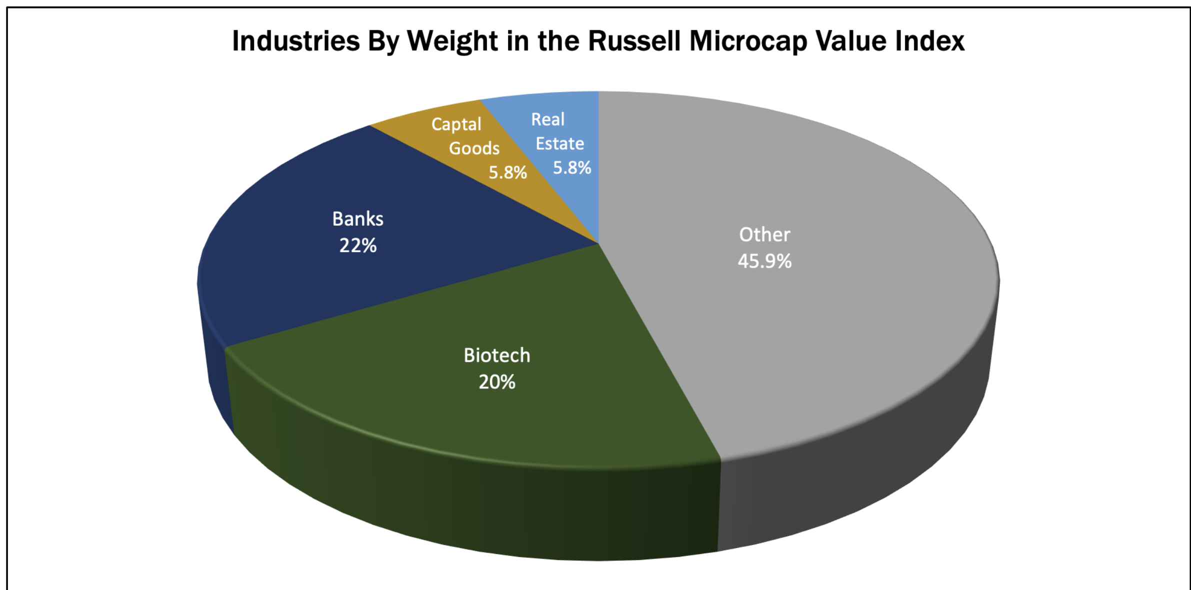
Commentary

Sector on the Run!

Part II

In the second and third quarter of 2018, we shared with you our observations about the rise of unprofitable companies and the biotech industry in the Russell Microcap® Value Index (the "Index.") In those commentaries, we noted that nearly 17% of the Index was projected to be unprofitable that year, compared to just 8% of the Index in 2013. Fast forward to August 15, 2022, and over 34% of the Index is projected to be unprofitable in the coming year, with 54% of the Index not posting any earnings in the last twelve months. What's behind this increase in unprofitable companies? The exponential growth in the number of companies in the biotech industry.

In September of 2013, biotech companies represented just under 3% of the Index. Today, these companies are the second largest industry group after banks, reaching over 20% of the total index. This represents a weight that is nearly twice the size of the next two largest industries combined (see chart below).



Midway through the third quarter, unprofitable companies have returned 30.4% compared to 20.1% for the Index. Biotech has posted a whopping return of nearly 36.9%. This same group of biotech companies has lost nearly $25 billion in its latest twelve months of operations and is not projected to generate income or cash in the foreseeable future. This type of speculative fervor has most recently been observed in cryptocurrency and meme stock activity.

Public markets have always had a share of companies that don't make money. Some are phasing out products or making other transitions. Some are spending on future growth rather than current profitability by investing in machinery, software systems and other productivity enhancing projects. Some are just plain duds. However, the large number of unprofitable companies currently in the Index is reshaping the profile of micro-cap benchmarks broadly, and the value indexes specifically.

We use benchmarks to measure our performance against a passive alternative. This is required of all managers who claim compliance with the Global Investment Performance Standards ("GIPS"). Using benchmarks helps investors determine if their managers are doing their jobs, and how well they are doing it.

Since inception, we have used the Russell Microcap Value Index as our Microcap benchmark. In our quarterly commentaries, we highlight certain items that make our portfolio profile and performance different from the Index.

To us, a good benchmark must be investable and measurable. As for the first criteria, small and micro cap companies in the US trade freely and well, but they do create capacity constraints for effective portfolio management. As for measurability, the Index creators publish results daily and use style adjustments that are built into certain published benchmarks to differentiate between value and growth characteristics. The most common of these style measures is the Price to Book Value ratio.

Point in time statistics, such as price-to-book, have historically been the preferred delineation between value and growth style tilts in benchmarks. This is as much a historical legacy as it is an attempt to smooth out the occasional volatility in income or cash flow that companies report. Because the biotech industry has been an equity market favorite, raising significant capital during the last several years, they have relatively low price-to-book ratios. Yet, no reasonable investor believes that biotech companies would fit in the realm of low valuation.

We are value managers. This means that we look for companies that are generating a good Return on Invested Capital and pay a low valuation for them. We look for common measures, including low price-to-earnings ratios, low enterprise value-to-EBITDA and high free cash flow yields. This combination of income and cash flow attributes allows us to see how the market is valuing the output that a company is producing. This is the reason that we do not own biotech stocks.

We believe that small and low multiple stocks will outperform the broader markets over the longer term. We've written several commentaries on why this is, and how inexpensive the market looks today. In fact, excluding the biotech sector, small company valuations are near historic lows. As we wind our way into next year, we believe that any sustained increase in overall demand is going to have a slingshot impact on earnings, which should improve prices of small company stocks overall.

Index weightings will come and go. Markets will move and change. We have no influence on these trends. Instead, we remain focused on the prudent judgment of future cash flows and paying a reasonable price for the companies in our strategy. At Pacific Ridge, we believe in the fundamental basics of valuation that have guided our team through investment cycles during each of the last four decades. We look forward to speaking with you about the opportunities in small and micro cap investing.

Sincerely,

Pacific Ridge Capital Partners