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MICRO-CAP INSIGHT

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The feature story this issue will be one of the most valuable, useful and instructive short articles about investing that you may ever read. This is true because we present simple facts that contradict the two most widely and strongly held beliefs about investing. These beliefs are not just wrong, these beliefs keep investors from ever making real money investing! These two beliefs are:

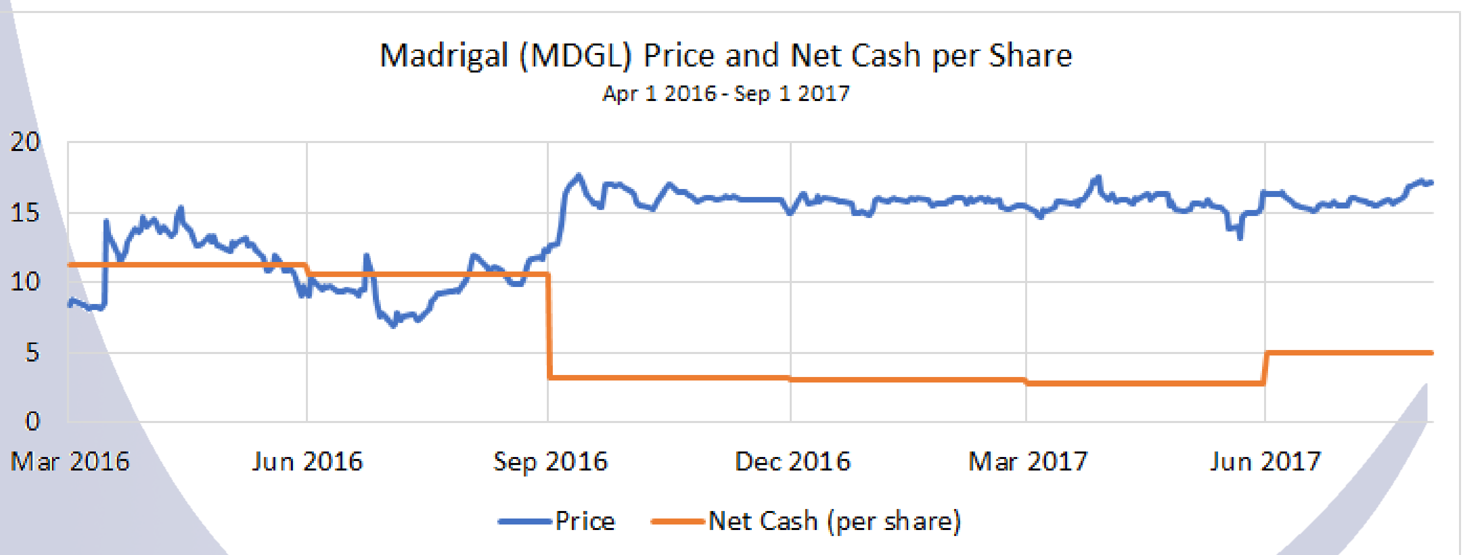
"Low risk investments yield the lowest returns; one must take very high-risks to produce very high returns." This is false! The truth is closer to: "One can make very high profits on stocks, 10, 20, even 50 times one's investment, and still avoid the highest-risk stocks"; and

"Stocks' prices are established by investment experts who know what a stock is worth. Therefore, if a stock trades at $6.89 per share, it must be worth $6.89 per share, and if it trades at $68.90 per share, it must be worth $68.90 per share." This too is false! In a short sentence, all I can do is make a broad general statement about "investment risks": The higher the price of a stock is from its "Net Liquid Worth", the greater the risk is of the share price falling. And the closer a stock's price to its Net Liquid Worth the lower the risk is of its share price falling. That is not to say that a stock will or will not fall; these are broad generalizations. However, they provide insight into useful and less risky strategies than just buying large, very popular name-brand stocks that in fact have very high risks.

The chart below clearly shows investors had a 17-month period from April 1st, 2016 through Sept.1st 2017 when they could have been accumulating stock in Madrigal at an average price to net cash of 3.5 times.

Madrigal's pricing proves the pricing mechanism for stocks is not "efficient" (thank goodness), and therefore no financial expert can predict success (again, thank goodness). If the price of a stock always reflected its "true" risks and opportunities, making a killing would be impossible without outright gambling; we do not advise that.

Moreover, this chart is exciting because it illustrates that investors can find companies with tremendous growth potential at prices that are so low (relative to their net cash, per share) that the stock's near-term risk of decline is very low. One can read news during such times as it comes forward, evaluating the risks as news is produced, but buying only when the risk of loss is greatly diminished because of the cash on the balance sheet. Capitalism lives!!



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The Madrigal Pharmaceuticals story:

On August 1, 2016, Madrigal Pharmaceuticals (MDGL) was a $27 million micro-cap company (at $6.89 per share with 3.94 million shares outstanding). What made this an exceptionally low-risk stock, at the time, was the fact that it had about $40 million in Net Cash, about $10 per share. Of course, they were spending this cash in R&D, but for some time, an investor could buy the stock with low risk, watch for news, and decide to sell IF positive news was not forthcoming prior to the company burning up its cash. Importantly, in every quarterly report subsequent to August 1st, MDGL has reported an increase in cash, so at no time after buying would an investor have had to consider selling their stock in MDGL because the company was running out of cash.

The company's stock now trades at about $281.00 per share, it has a market cap of $4.0 billion and, at time it has only $177 million in shareholder equity.

Who took more risk?

The buyer of a company with a $27 million market cap, with $40 million in equity? Or

The buyer of a company with a $4 billion market cap, with $177 million in equity?

Who has the greater potential for profit?

The person buying a company with a $27 million market cap? Or

The person buying a company with a $4 Billion market cap?

The buyer who paid $7 per share and held their stock until today made 40 times their investment.

For today's buyer to make 40 times their investment, the stock would have to rise to a $160 billion market cap. There are only 5 biotech or pharm companies in the world with a $160 billion market cap; what are the chances of MDGL rising 40-fold? They approach zero. What are the chances of MDGL falling 50% or more? They are very substantial!

Who is smarter, the big cap sheep, or the extremely cautious Micro Cap Insightful investor?

MDGL	8/1/2016	6/5/2018
Price	$6.89	$283.16
Cash (millions)	$43.0	$182.8
Market Cap (millions)	$27.1	$4,035

Autoweb (AUTO) - A Fallen Star; Could It Be a Buy Now?

Today we'll take a look at Autoweb (AUTO). It's a very interesting company – not so much because of what they do, as what they do is pretty simple; rather, it's interesting because we can learn a lot from looking at their financials and the changes over the past couple of years. The lessons we can learn are important. The stock has fallen by about 80%, and if we want to be successful investors, we really need to understand why the stock would fall 80% even though their sales rose in the same period. And their debts fell! So by basic financial analysis, this company did not deteriorate in a significant way - to the contrary, in fact.

I am talking about this company in particular today because it may represent an excellent buying opportunity. At Micro-Cap Insight, we don't **recommend** stocks.; we **discuss** them. We make observations about their changes in price and market capitalization, and we try to explain those changes by looking at fundamental changes on the companies' financial statements. At Micro-Cap Insight, we are not in the business of forecasting anything. We're in the business of trying to better understand and share our insights and understanding with our readers about what causes prices to fall and to rise.

So right now, with no knowledge or appreciation or estimations of the future, people can buy shares of Autoweb for $3.56 per share, which represents a total price tag on the market of less than $46 million for the company. It has revenues of $137 million and liabilities of $16 million. The way I translate that, you can buy those sales for about $.34, and you can buy a company with revenue much higher than liabilities. In addition, Autoweb had revenue growth of about 70% over the past decade.

Again, I remind you that at MCI we are not in the business of recommending that you buy the stock.

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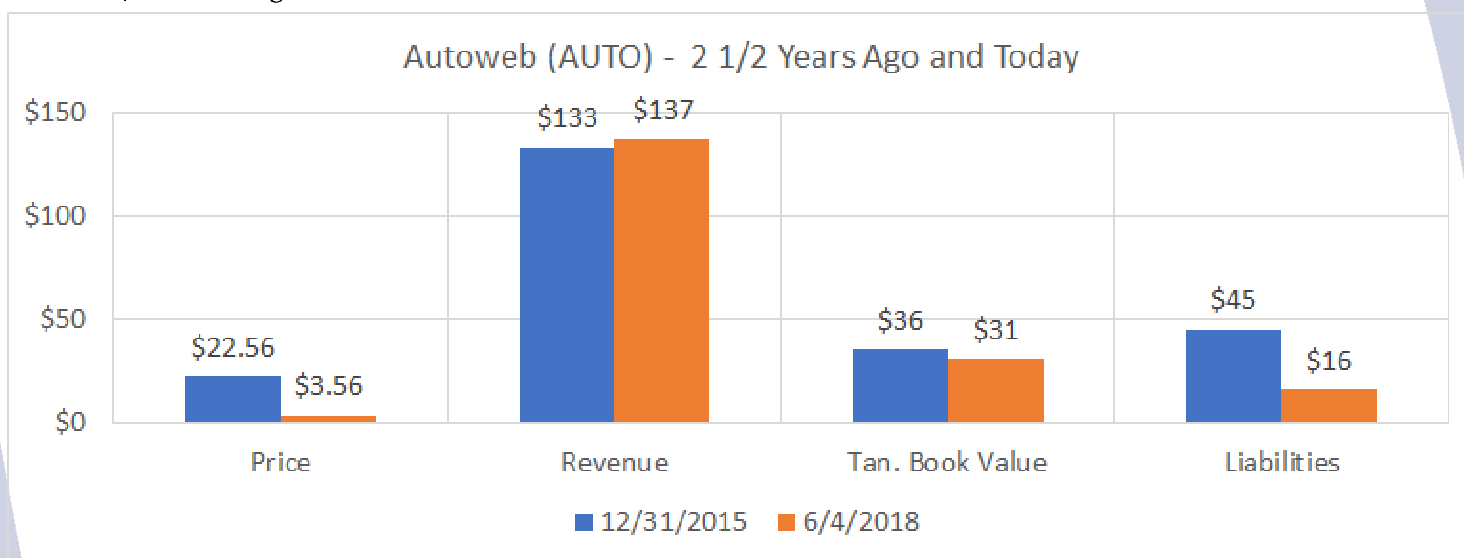
We instead point out what we think are interesting lessons to be learned by talking about a company and highlight potential stocks that could be very attractive. And we will also talk about companies think are very dangerously priced; that is, we think they could fall a great deal.

2 ½ years ago, Autoweb was trading at $24.57 per share. Its previous 12-month revenues were $123 million, its liabilities were about $48 million, and its tangible book value was $36 million. 2 ½ years later, let's look at their prices: down by about 82%! Its revenues are $137 million; its liabilities are down to $16 million, and its tangible book value is down to $31 million.

Why did the stock fall from $24 and change to $3 and change, when sales not only did not crumble, but went up?

Key Lesson: 2 ½ years ago this company traded at more than two times revenue in a low-margin business. By low-margin, I mean single-digit profit margin; i.e., 2%, 4%, even 6%. In this company, the revenues were $123 million and the market capitalization was $258 million. If you would buy it at $258 million, with a profit margin of 4% and sales of $123 million, it would take you approximately 52 years to break even! Whereas today this company's market cap is only $46 million, and it has $137 million of revenues. If the profit margin is 5%, it will only take you 7 years to break even. I'm not suggesting that I know what the future sales growth will be. Only if you have confidence in the future growth of sales and earnings of this company should you be considering buying. I'm simply pointing out that the ratio of sales to price (revenues divided by market cap) is a very important consideration when buying stocks of any size. Simply put, the lower the price to sales ratio, the higher the probability, all things being equal, you will enjoy a substantial period of growth.



Generation Next Franchise (VEND) - Is VEND Over-Priced (again)?

What we can learn from the past

Generation Next Franchise is involved in the vending machine franchising industry. They sell franchises to people who install the vending machines in various places, buy and maintain an inventory of products that are sold in the machines, maintain the machines and collect the revenues from the machines. That's their business.

I'm sure there's a lot more to it. But we're neither experts on the vending machine industry nor the franchising industry. But we know how to study and evaluate the relationship between company's finances and its stock price movements. That's our business.

In February 2014, VEND's shares traded at $10 a share. They had about 25 million shares outstanding, so their market cap was about $250 million.

At that time, its previous 12-month revenues were about $3 million, and their liabilities were about $5 million.

I'm sure, back in 2014, we would've been asking "why would a company with just a few million in sales have a $250 million market cap?" We wouldn't "know" if that market cap was justified but we'd have a good estimate of the riskiness of the stock. Although we definitely want to find stocks that have exceptional potential to appreciate, we're also very focused on avoiding losing our shirts as we hunt for such great opportunities. So, when look at any company the first question is: "What is their market cap" Then, we ask and seek answers to the question, "how well might we be rewarded IF the company in review meets their stated objectives", then we ask, "what is the evidence that the company will meet its objectives, what are the risks of failure and what are the chances (probabilities) of achieving success?"

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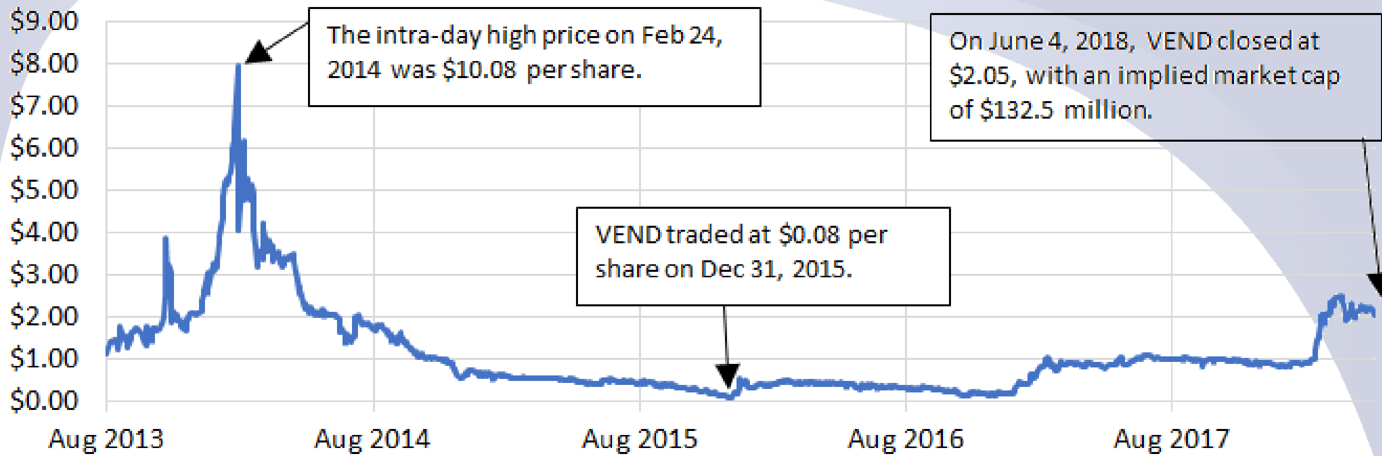


We ask, could their market cap be justified by the fact that:

...the company currently has "real equity" of $250 million? Or,

...do they have current equity of $100 million and we can see clearly, and we are highly confident, that they will build equity greater than $150 million in the next 3, 5 or even 8 years? Or,

...is there some other "rational" justification for the company's market capitalization hovering near a quarter of a billion dollars? With only a few million in sales, a high level of debt and negative equity of about $2.2 million? Or,

...could the simplest and more likely explanation be that the stock was highly overpriced?

The answer: Looks like number 4 was the right answer:

In the next 20 months, the stock's price fell 99%; From February 2014 to December 2015 the stock fell from $10 to $0.08. It begs the question, "what were investors thinking when they paid $10 a share?" and "what evidence did they have to support their investment thesis?"

No one can answer those questions. But it's very important that you understand when you're buying a stock that if you do not know how to fully assess risks, you will likely lose a very high percentage of your investment. Moreover, unless you become expert in evaluating risks and avoiding very high-risk stocks, you may run out of capital before you find that one stock that could have changed everything for you.

We've reviewed some financial information about the company in 2014, when its stock was soaring. We again reviewed some financial metrics of the company after it collapsed to $0.08. Let's review the company again today.

The company's trailing 12-month revenues are $1.1 million. Their total liabilities exceed $46 million. They have *negative* tangible book value of $17.7 million. And their market cap is now $132.5 million.

Again, I'm at a loss to understand why anybody would think that this company is NOW worth $132 million. I can't say that the company won't make a great deal of money in the future. But how could one be certain that this company is worth $132 million right now? What evidence would make someone think this?

I've been investing and speculating (two very different activities) for over 40 years. I would not still be investing and speculating if I didn't have confidence that, although investing in general is very risky, when proper precautions are taken one can find companies with significant growth potential, which have clear and compelling indications of their future success and which don't require a wayward degree of risk.

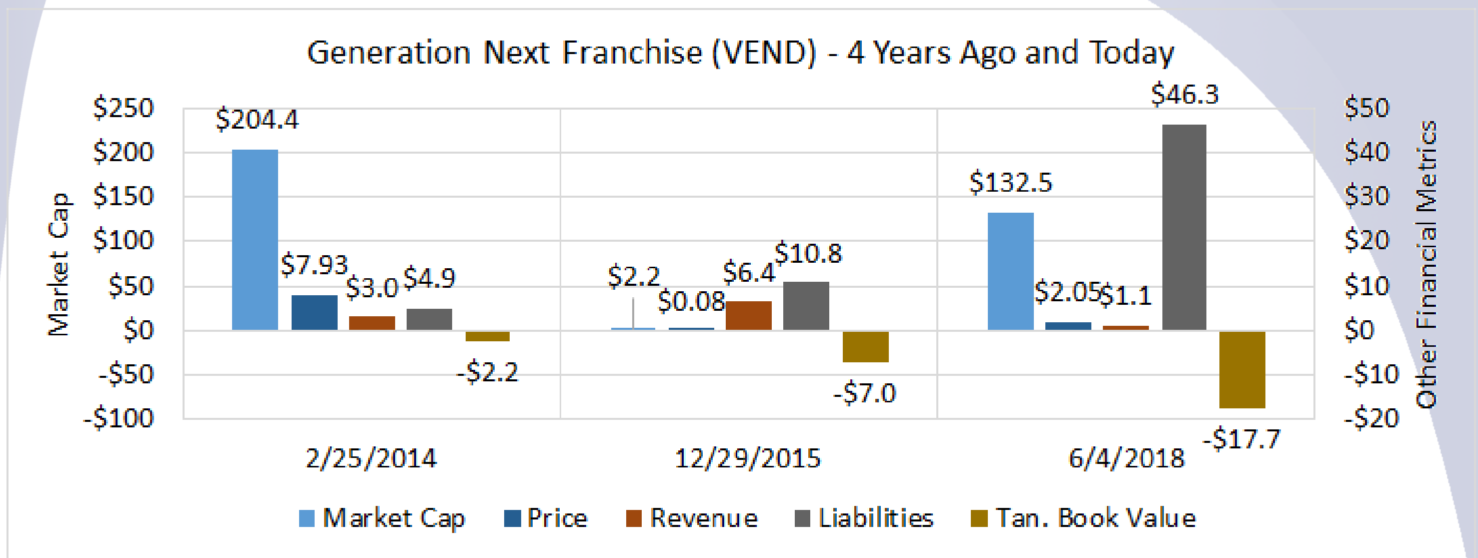
Please understand, I don't have expertise in evaluating the prospects of company's in the vending machine industry, the franchising industry or evaluating the probabilities of success of this specific company. However, I will promise you that if you're patient and systematic in evaluating risks and rewards, you (we) will occasionally find companies with compelling evidence of their appreciation potential with far less risks as well. The past is NOT the future, maybe they can turn this company generate meaningful revenues and profits. But be realistic, how big is their potential? Will they discover a cure for cancer, a new way of generating low cost energy or make a tremendous oil discovery? When taking big risks, make sure the potential rewards are compelling enough to justify the risk taking.

I've been studying financial statements since 1976. I consider myself pretty good at it. I have to admit, looking at their income statement and their balance sheet, I'm stumped. For example, over the past 4 quarters, they've increased their number of shares outstanding from 30 million to 55 million, an increase of 83%. I fail to see the value in this company. I have to admit, again, it wouldn't be the first time I've failed to see value in companies that have subsequently appreciated in their share price.

—Cont'd page 5

But I have to tell you I've seen more companies whose financial statements were so complex that I didn't understand them, that have subsequently failed, than those companies with overly complex financial statements which have subsequently succeeded.

Remember, although we spend a great deal of time and effort to find exceptional opportunities, we do not recommend stocks here; we discuss them to help you understand the risks of investing as well as the potential rewards.

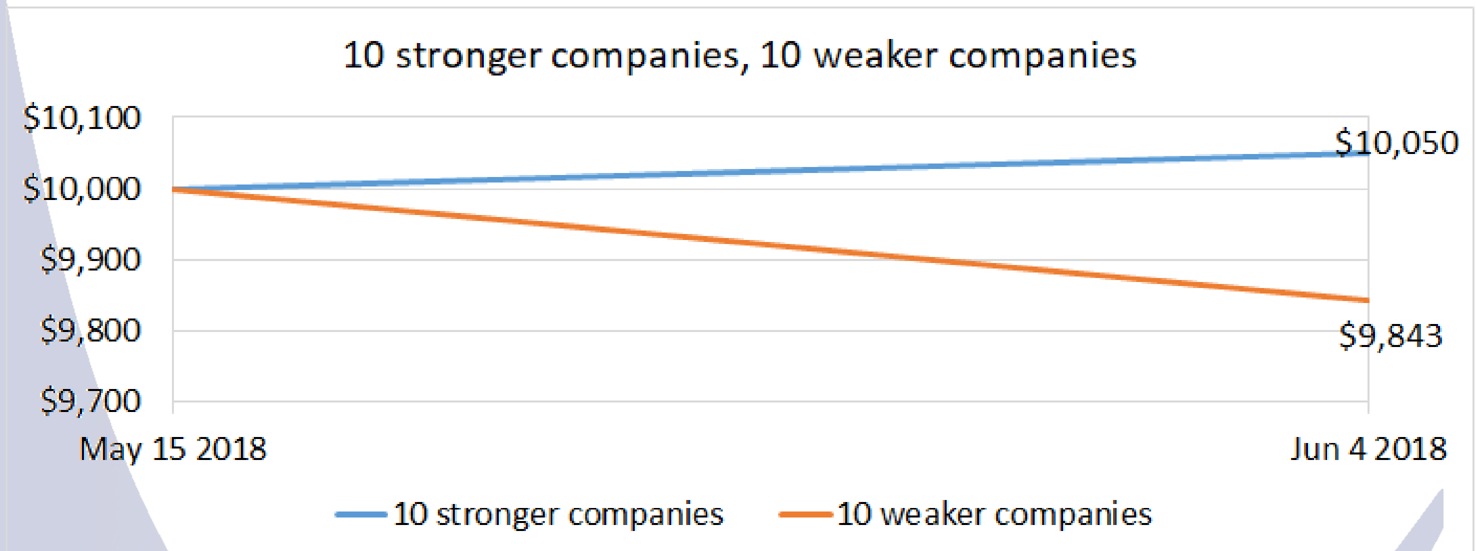


Tracking the 20 "Safer" and "Questionable" Stocks - Period 2

In the previous issue, we introduced you to 20 stocks, 10 of which we called "safer", the other 10 "questionable".

We make no recommendations as to which stocks among the 20 included in this group would go up or down. Rather, we've used them as a case study to introduce you to the idea of investing in financially-sound companies.

The chart below illustrates the profit or loss one would have gained (lor lost) if they had invested $10,000 equally into the stocks in each group on May 15th, 2018, the day of our first report. Which portfolio will do better? The answer may be instructional.



Micro-Cap Insight is published by Raymond M. Mullaney. **MCI** is dedicated to helping you identify stock risks, understand stock risks and avoid unnecessarily risky stocks while you're searching for those stocks that could increase the value of your portfolio 5, 10 or even 25-fold.

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