

Equities

31 October 2011 | 16 pages

Small/Mid Cap Topics

Updating De-equitization Trends

■ Equities

- **De-equitization Distillation** — Trends in equity supply within the Russell 2000 and Mid Cap indices over the past decade imply an ongoing de-equitization influence. Increased de-equitization activity tends to coincide with stronger markets, and is primarily driven by M&A within small cap. For mid cap, drivers are more balanced between M&A and repurchase. Given trends through Q3, we expect modest de-equitization for 2011 for both small and mid cap.
- **Is M&A Back? Focus on Energy and Health Care** — An analysis of YTD M&A trends by month indicates that deal counts are not back to pre-selloff levels. However, there does seem to be a trend towards “buying growth” in the Energy and Health Care sectors, resulting in a disproportionate amount of deals in these sectors relative to history. An emphasis on the natural gas opportunity in the US is a key Energy growth theme, while Medicare and R&D outsourcing represent key themes for Health Care growth.
- **Repurchase on the Rise, Revisited** — Following a Q4 '10 and 1Q'11 pullback, RUT repurchase activity reaccelerated in Q2 '11, moving to a post 1Q'09 recovery high. Given the connection between EBIT and repurchase that we established in our earlier work, when combined with Q3 lower share prices, we expect that repurchase activity should continue to increase into year-end.
- **Repurchase Screen** — We include a list of CIRA Buy-rated stocks under \$5B in market cap with authorized but uncompleted repurchase programs. From our SMID “Value Creators” focus list, we highlight OC, CVD, JAH, WFR, ANN, FINL, and CCOI. We also highlight URBN from CIRA's Top Picks Live! conviction list.
- **Stock Issuance** — Offsetting the M&A and repurchase “de-equitization” effects is the “equitization” that comes with new equity issuance. To provide some perspective on the “equitization” offset to the “de-equitization” trend, we look at recent share issuance activity. Generally speaking, within small/mid cap, share issuance is driven by secondary offerings, although we note that a higher percentage is made up of IPO's for the RUT. YTD trends show a dropoff in issuance since the recent selloff, with a modest uptick in October.

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See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.

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Summary

We find that the overall tendency in the small/mid cap markets over the past decade has been toward de-equitization.

With several high profile M&A deals in the headlines in the past few weeks, we find the timing appropriate to provide an update on recent “de-equitization” trends within the small and mid cap asset classes. De-equitization is a term used to describe a shrinkage of the equity markets, primarily as a function of share repurchases and cash-financed M&A, against a backdrop of limited IPO activity. As markets are ultimately driven by supply and demand, a reduction in the supply of equity should help to lift markets, *ceteris paribus*.

Looking at trends in equity supply within the Russell 2000 and Mid Cap indices over the past decade or so, we find that the overall tendency has been toward de-equitization. Increased de-equitization tends to coincide with stronger markets, and is primarily driven by M&A within small cap. For mid cap, drivers are more balanced between M&A and repurchase.

We expect that ongoing “build vs. buy” decisions will lead to an increased appetite for many companies to pursue M&A opportunities. That said, higher stock prices seem to be a necessary precursor to both acquirer and target willingness.

Furthermore, recent deal announcements raise the question of whether the deals in question are one-off events, or indicative of a renewed trend towards increased M&A. Our view is that M&A will typically be an important aspect of the small/mid cap dynamic, but that it is premature to declare a resurgence in small and mid cap M&A. If anything, the Q3 selloff has actually led to reduced activity. However, there does seem to be a trend towards “buying growth” in the Energy and Health Care sectors, resulting in a disproportionate amount of deals in these sectors relative to history. Going forward, against a slow growth economic backdrop, we expect that ongoing “build vs. buy” decisions will lead to an increased appetite for many companies to pursue M&A opportunities. That said, higher stock prices seem to be a necessary precursor to both acquirer and target willingness to engage in such activity.

Small and mid cap repurchase activity rose to a post 1Q’09 recovery high in Q2.

In early January, we published a note (“Repurchase on the Rise”) where we examined historical repurchase trends for the Russell 2000 and Mid Cap indices. Following a Q4 ’10 and 1Q’11 pullback, RUT repurchase activity reaccelerated in Q2 ’11, moving to a post 1Q’09 recovery high. RMC repurchase activity has moved to a similar recent high, but did not experience a Q1 fall off similar to small. Data availability prevents us from a Q3 update.

That said, in our earlier note, we drew a connection between small and mid cap EBIT trends and repurchase activity. Given the ongoing earnings improvement experienced at the small/mid cap index level through Q3, and combined with lower share prices since the end of Q2, we expect that second half small/mid cap repurchase activity will show a continued increase over the first half, thus adding to the nearer term de-equitization effect.

We also provide a list of CIRA Buy-rated stocks under \$5B in market cap with authorized but uncompleted repurchase programs. From our SMID “Value Creators” focus list, we highlight OC, CVD, JAH, WFR, ANN, FINL, and CCOI. We also highlight URBN from CIRA’s Top Picks Live! conviction list.

Generally speaking, share issuance is driven by secondary offerings, although we note that a higher percentage is made up of IPO’s for the RUT.

To provide some perspective on the “equitization” offset to the “de-equitization” trend, we look at recent share issuance activity. Generally speaking, share issuance is driven by secondary offerings, although we note that a higher percentage is made up of IPO’s for the RUT. YTD trends show a dropoff in issuance since the recent selloff, with a modest uptick in October. Intuitively, and with historic justification, it’s clear that small and mid cap issuance trends are tied to underlying market conditions. Therefore, we believe that the coming months’ issuance outlook should continue to increase from recent levels, but with some underlying market stability as a necessary precursor to this.

De-equitization

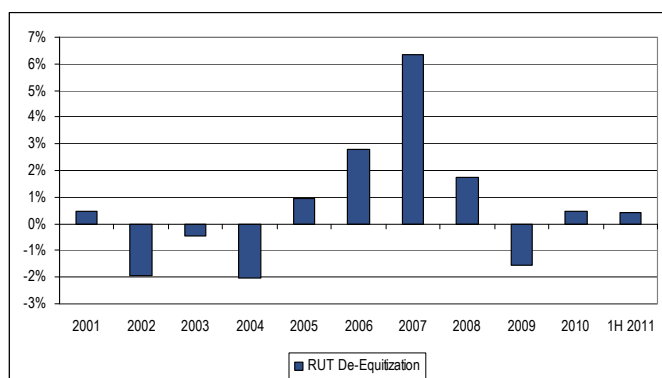
De-equitization is a term used to describe a shrinkage of the equity markets, primarily as a function of share repurchases and cash-financed M&A, against a backdrop of limited IPO and other new issuance activity.

CIRA' global strategists have highlighted de-equitization as a key theme for equity markets over the past few years. De-equitization is a term used to describe a shrinkage of the equity markets, primarily as a function of share repurchases and cash-financed M&A, against a backdrop of limited IPO and other new issuance activity.

Figures 1-4 below show the de-equitization trend for the Russell 2000 and Mid Cap indices since 2000. Furthermore, we decompose this trend down into its three key components: repurchase, M&A, and offsetting new issuance. We make the following observations:

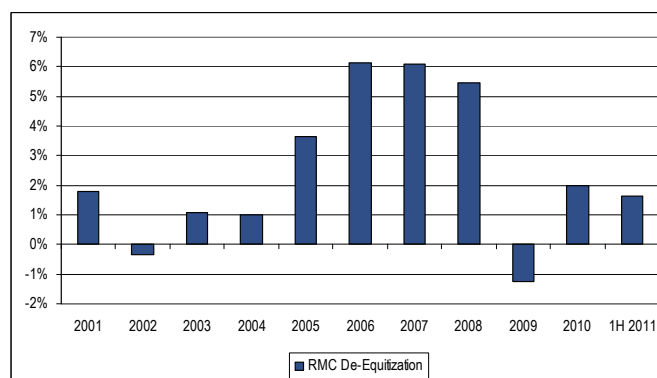
- The supply of small cap equity has contracted in 7 of the past 11 years. For mid cap, equity supply has expanded in only two years.
- Small cap de-equitization is primarily driven by M&A activity, while mid cap is more balanced between M&A and repurchase.
- Increased de-equitization tends to coincide with strong market performance.

Figure 1. Russell 2000 De-equitization



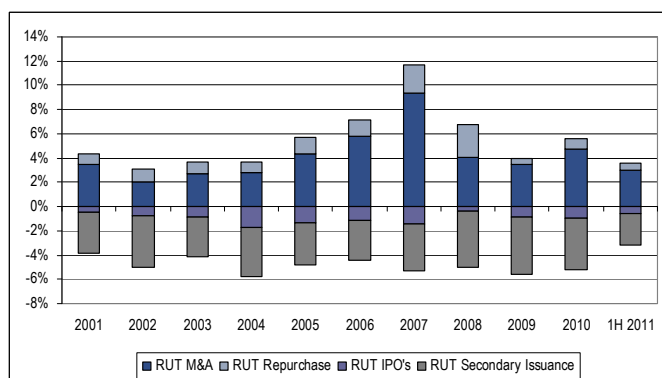
Source: Bloomberg, FactSet

Figure 2. Russell Mid Cap De-equitization



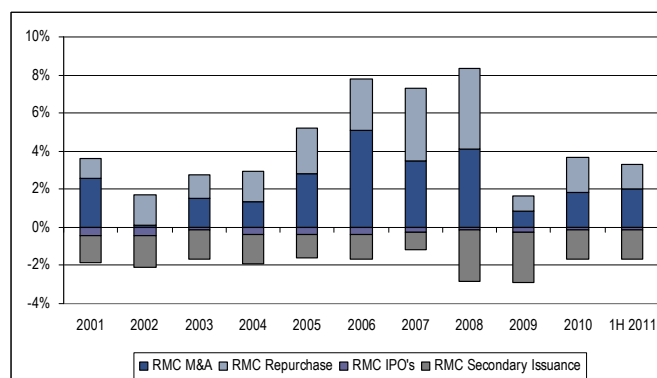
Source: Bloomberg, FactSet

Figure 3. Russell 2000 De-equitization Decomposition



Source: Bloomberg, FactSet

Figure 4. Russell Mid Cap De-equitization Decomposition



Source: Bloomberg, FactSet

Mergers & Acquisitions

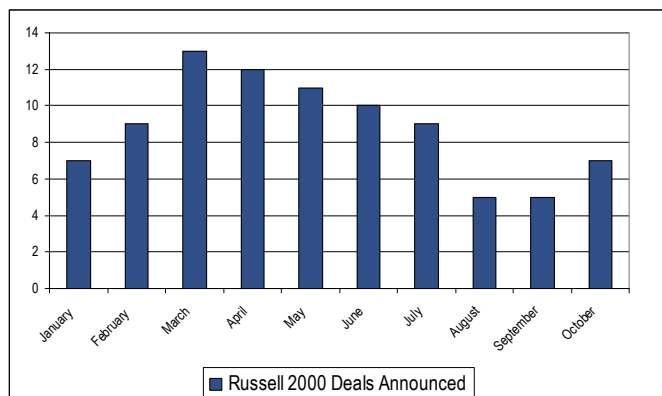
Deal flow has not yet rebounded to levels seen prior to the late July - early August selloff, but a disproportionate amount of deals are getting done in the Energy and Health Care sectors.

There have been several high-profile deals with small and mid cap targets announced recently. This raises the question of whether these deals are indicative of a more general trend, or if they are simply one-off events. The answer is both yes and no. No in the sense that deal flow has not yet rebounded to levels seen prior to the late July - early August selloff. But, yes, in the sense that a disproportionate amount of deals are getting done in the Energy and Health Care sectors post-selloff, as compared to historical trends.

An analysis of monthly deals announced with targets in the RUT and RMC indicates that deal activity has not yet fully rebounded. (See Figure 5 and Figure 6) We view the RUT trend as a more reliable indicator, due to the larger sample size. We suspect that there are at least three reasons for this:

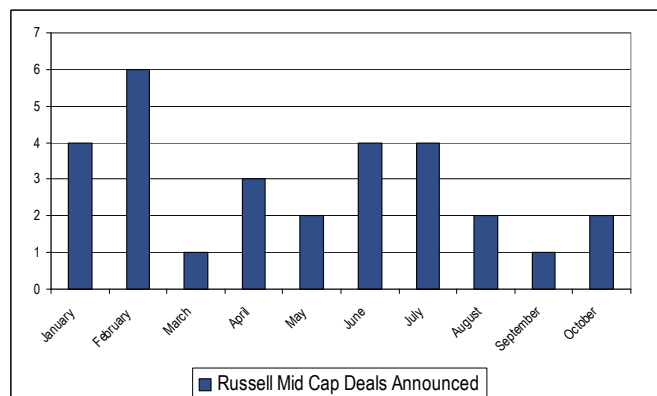
- Reluctance of strategic acquirers to do stock-based deals funded at lower stock prices (and related higher cost of equity)
- Tendency for target managements to cling to pre-selloff valuations
- Generally more cautious growth outlook and credit environment

Figure 5. Deals Announced with RUT Targets by Month (YTD)



Source: FactSet

Figure 6. Deals Announced with RMC Targets by Month (YTD)



Source: FactSet

Turning to the sectors, we find that of the 22 SMID* deals announced since the beginning of August, 5 (23%) have been in the Energy sector, while 6 (27%) have been in Health Care. In contrast, these sectors have accounted for a respective 6% and 15% of historical deal count, on average. We also note that a relatively high percentage of post-selloff deal announcements have been in the Consumer Discretionary and Tech sectors, although these percentages are not out of line with historical averages (2000 -2010). A summary table is provided in Figure 7, and a full list of deals can be found in Appendix 1.

* Targets in either the RUT or RMC

Figure 7. Deal Count Percentages by Sector: Recent Announcements and Historical Averages

Sector	Since August 1st	Historical Average
Consumer Discretionary	14%	16%
Consumer Staples	0%	3%
Energy	23%	6%
Financial Services	9%	19%
Health Care	27%	15%
Materials & Processing	0%	5%
Producer Durables	9%	6%
Technology	14%	19%
Utilities	5%	3%

Source: FactSet

Many recent transactions in Energy and Health Care can be characterized as “buying growth”.

To offer potential explanations for these sector trends, we turn to CIRA’s fundamental Energy and Health Care analysts. In short, many recent transactions in both sectors can be characterized as “buying growth”.

Key themes within Energy include:

- Growth in natural gas extraction
- Valuation disparity between C-Corps and MLP’s
- See Robin Shoemaker’s ranking of M&A candidates within his Oilfield Equipment Services coverage here: [Oilfield Equipment Services - M&A Deals Increased in 3Q11 but a Slowdown Looms](#)

Key themes within Health Care include:

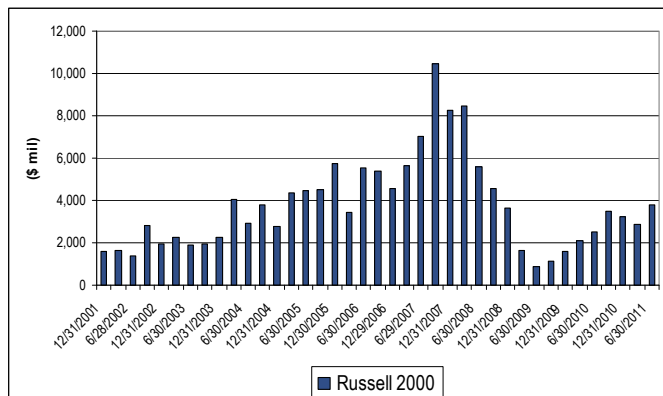
- Large managed care plans looking to improve their retail Medicare franchises
- Outsourcing of R&D
- See Carl McDonald’s thoughts on Managed Care deal trends here: [CI / HS: You Know What I Did Before I Got Married? Anything I Wanted To - Thoughts On The HealthSpring Acquisition](#)

Repurchase on Rise, Revisited

RUT and RMC repurchase activity reaccelerated in Q2 '11, moving to a post 1Q'09 recovery high.

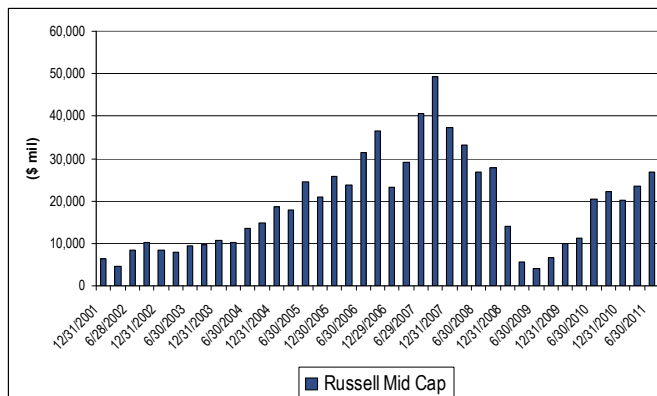
In early January, we published a note ("Repurchase on the Rise") where we examined historical repurchase trends for the Russell 2000 and Mid Cap indices. Figure 8 and Figure 9 contain an updated look at quarterly repurchase trends through Q2 '11. Following a Q4 '10 and 1Q'11 pullback, RUT repurchase activity reaccelerated in Q2 '11, moving to a post 1Q'09 recovery high. RMC repurchase activity has moved to a similar recent high, but did not experience a Q1 fall-off similar to small cap.

Figure 8. Russell 2000 Quarterly Repurchase Trends



Source: FactSet

Figure 9. Russell Mid Cap Quarterly Repurchase Trends



Source: FactSet

To this date, there have not been a sufficient number of Q3 filings to enable us to quantify the magnitude of repurchase activity during the tumultuous third quarter. Thus, we aren't able to more definitively measure trends in share repurchase following the Q2 increase. That said, in our earlier note, we drew a connection between small and mid cap EBIT trends and repurchase activity. Given the ongoing earnings improvement experienced at the small/mid cap index level through Q3, and combined with lower share prices since the end of Q2, we expect that second half small/mid cap repurchase activity will show a continued increase over the first half, thus adding to the de-equitization effect.

While repurchase activity is clearly an important aspect of a view toward de-equitization effects at the index level, the dynamic is more difficult to quantify at the company specific level. For example, isolating repurchase effects across Citi's small/mid coverage universe is fraught with exceptions.

That said, on a stock by stock basis, identifying management intent can certainly be a useful tool. Thus, we've screened CIRA's coverage universe for companies under \$5B in market cap with authorized but uncompleted repurchase programs. (See Figure 10) Note that this is not an exhaustive list, due to data limitations, but does provide a good representative sample of small and mid cap firms repurchasing their stock.

From our SMID "Value Creators" focus list, we highlight OC, CVD, JAH, WFR, ANN, FINL, and CCOI. We also highlight URBN from CIRA's Top Picks Live! conviction list.

Figure 10. CIRA Buy Rated Coverage Under \$5B with Authorized but Uncompleted Repurchase Programs *

Ticker	CIRA Rating	Price 10/28/2011	Mkt Cap	Number of Programs	Program Type	Authorized Shares	Authorized Value	Completed Shares	Completed Value	Average Price
ALB	1	\$55.13	\$4,893	1	Shares	15.00	\$606	3.00	\$178	\$59.38
TW	1	\$65.06	\$4,821	2	Mult	2.27	\$149	0.40	\$25	\$61.16
SUN	1H	\$39.33	\$4,764	1	Value	23.98	\$1,000	0.00	\$0	\$0.00
URBN	1	\$28.10	\$4,325	1	Shares	18.00	\$586	2.34	\$67	\$28.76
PRE	1	\$62.50	\$4,234	1	Shares	7.00	\$482	0.00	\$0	\$0.00
AXS	1	\$31.20	\$4,033	1	Value	24.22	\$750	0.00	\$0	\$34.25
X	1H	\$27.86	\$4,012	1	Shares	8.00	\$176	0.00	\$0	\$0.00
CBI	1H	\$37.84	\$3,734	1	Shares	10.00	\$286	0.32	\$11	\$34.69
DHI	1	\$11.61	\$3,669	1	Value	8.68	\$100	3.54	\$39	\$10.88
GPN	1	\$46.84	\$3,668	1	Value	2.18	\$100	1.85	\$81	\$43.43
OC	1	\$29.47	\$3,562	1	Shares	10.00	\$217	2.82	\$85	\$30.24
RNR	1	\$67.94	\$3,516	1	Value	25.95	\$1,815	0.00	\$0	\$69.78
IACI	1	\$41.04	\$3,487	1	Shares	20.00	\$763	4.80	\$173	\$35.97
FL	1	\$22.52	\$3,445	1	Value	13.81	\$300	1.26	\$29	\$23.40
VAL	1	\$35.83	\$3,349	1	Shares	15.00	\$493	0.00	\$0	\$36.29
LAZ	1	\$28.22	\$3,302	1	Value	12.13	\$450	2.39	\$94	\$39.22
CVD	1	\$52.90	\$3,213	1	Shares	9.00	\$534	0.00	\$0	\$0.00
GES	1	\$34.59	\$3,209	1	Value	6.56	\$250	0.00	\$0	\$41.44
LEN	1	\$17.05	\$3,188	1	Shares	40.00	\$588	0.00	\$0	\$0.00
DRE	1	\$12.58	\$3,180	1	Value	64.24	\$900	0.02	\$0	\$14.43
JAH	1	\$32.97	\$3,016	1	Value	4.35	\$150	0.28	\$9	\$31.68
HBI	1	\$27.32	\$2,654	1	Shares	10.00	\$295	0.00	\$0	\$0.00
HNT	1	\$28.94	\$2,578	1	Value	9.35	\$300	0.87	\$27	\$31.14
HME	1	\$59.68	\$2,447	1	Shares	13.00	\$791	0.00	\$0	\$60.52
SATS	1	\$26.74	\$2,313	1	Value	29.08	\$1,059	0.00	\$0	\$0.00
HMA	1	\$8.89	\$2,259	1	Value	36.13	\$250	0.00	\$0	\$10.96
BRCD	1H	\$4.51	\$2,213	1	Value	145.99	\$800	1.48	\$10	\$6.80
TECD	1	\$50.50	\$2,192	1	Value	4.29	\$200	3.20	\$149	\$46.52
PPS	1	\$40.29	\$2,034	1	Value	4.91	\$200	0.00	\$0	\$0.00
CNC	1	\$35.56	\$1,791	1	Shares	4.00	\$115	0.00	\$0	\$33.20
SKS	1	\$10.94	\$1,750	1	Shares	70.00	\$752	0.00	\$0	\$0.00
SMTC	1	\$25.32	\$1,678	1	Value	2.15	\$50	0.00	\$0	\$0.00
SHOO	1	\$37.55	\$1,607	1	Shares	15.19	\$570	0.00	\$0	\$0.00
WFR	1H	\$6.64	\$1,530	1	Value	117.23	\$1,000	0.00	\$0	\$0.00
HAIR	1	\$34.15	\$1,499	1	Shares	1.45	\$49	0.00	\$0	\$33.13
MGLN	1	\$51.79	\$1,474	1	Value	9.32	\$450	2.50	\$120	\$47.98
ANN	1	\$27.75	\$1,449	1	Value	23.13	\$600	0.00	\$0	\$27.38
CVG	1	\$11.11	\$1,333	1	Shares	50.00	\$682	1.48	\$19	\$13.15
MDP	1	\$27.94	\$1,257	1	Shares	5.00	\$113	0.34	\$9	\$26.22
BPI	1H	\$21.83	\$1,147	1	Value	3.00	\$75	1.89	\$44	\$23.15
SNX	1	\$29.06	\$1,068	1	Value	2.47	\$65	0.00	\$0	\$0.00
FINL	1	\$20.59	\$1,067	1	Shares	5.00	\$96	2.14	\$45	\$20.99
IART	1	\$38.35	\$1,055	1	Value	1.57	\$75	0.31	\$15	\$48.56
IDTI	1H	\$6.24	\$912	1	Value	27.88	\$225	3.02	\$24	\$7.89
CCOI	1	\$15.84	\$730	1	Value	2.94	\$50	0.00	\$0	\$0.00
MFB	1	\$25.02	\$588	1	Value	2.49	\$70	0.00	\$0	\$0.00
GTS	1	\$19.44	\$562	1	Value	1.38	\$30	0.00	\$0	\$0.00
NTSP	1H	\$6.21	\$555	1	Value	2.50	\$25	1.19	\$11	\$8.99
CSGS	1H	\$14.58	\$504	1	Shares	35.00	\$647	0.00	\$0	\$19.20
CBFY	1	\$8.42	\$259	1	Value	1.14	\$15	0.27	\$4	\$13.03
BZH	1H	\$2.20	\$166	1	Shares	11.00	\$37	0.00	\$0	\$0.00

Source: FactSet

For additional historical perspective, please refer to our "Repurchase on the Rise" Topics note: [Small/Mid Cap Topics - Repurchase on the Rise](#).

* Data as of latest quarterly filings

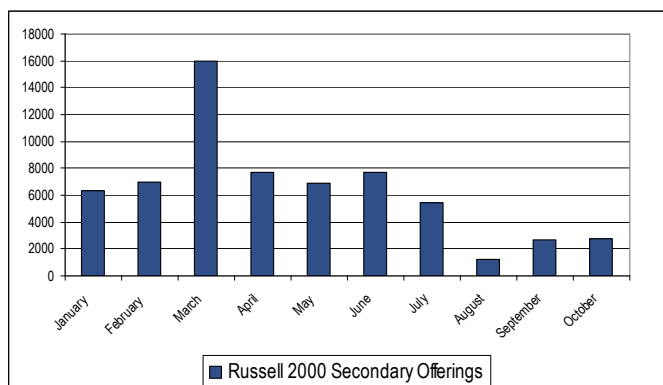
Issuance

Issuance tends to be more stable than repurchase or M&A, and that it is primarily driven by secondary offerings, as opposed to IPO's.

Share issuance represents “equitization” of the indices, and thus provides an offset to the “de-equitization” caused by M&A and repurchase activity. Figure 3 and Figure 4 above show that issuance tends to be more stable than repurchase or M&A, and that it is primarily driven by secondary offerings, as opposed to IPO's. However, we do note that IPO's make up a larger percentage of small cap issuance relative to IPO influence on mid cap issuance.

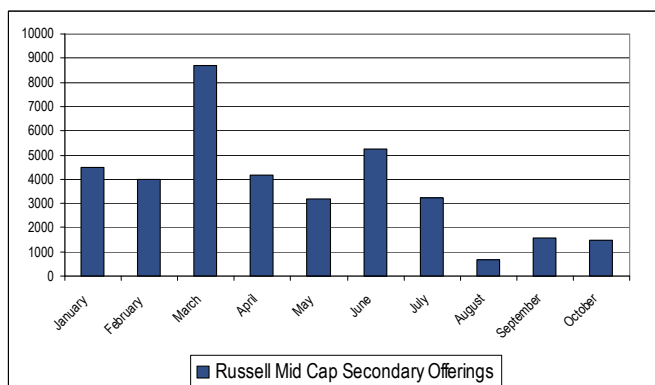
Also, there does tend to be more issuance as a function of robust market conditions. Although that trend may get blurred looking at annual data, YTD issuance trends by month tell that story very clearly. A look at dollar volume of secondary offerings by month for RUT and RMC constituents shows that secondary issuance has made somewhat of a rebound from its post-selloff lows in August, but is still at only about half of July levels. (See Figure 11 and Figure 12)

Figure 11. Russell 2000 Secondary Offering Volume by Month (YTD)



Source: Bloomberg

Figure 12. Russell Mid Cap Secondary Offering Volume by Month (YTD)

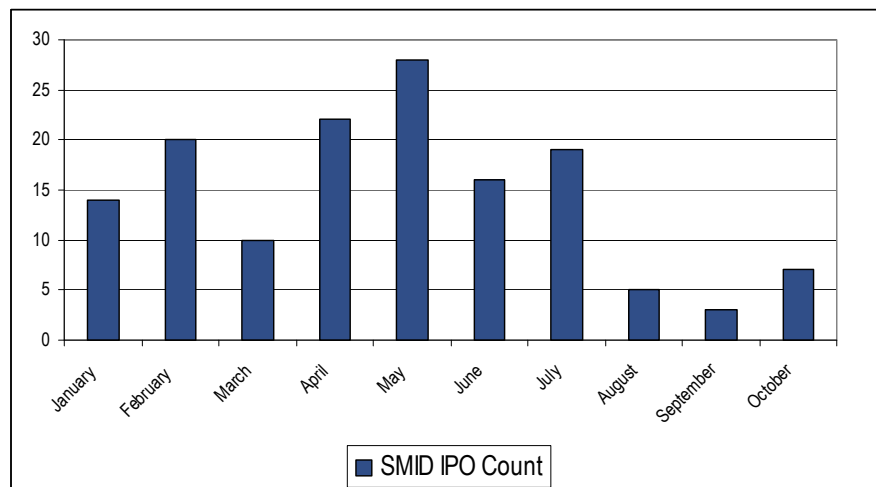


Source: Bloomberg

Russell only adds initial public offerings to its indices quarterly. Therefore, data on index constituents provides a somewhat limited indication of trends in IPO activity in recent months. Therefore, we look at the number of SMID IPO's (defined as under \$5B) in. Once again, the available data suggests that IPO activity has begun to rebound following the late July – early August selloff, but that it remains subdued relative to earlier in the year.

Similar to our takeaways regarding M&A activity, we expect that share issuance (i.e. equitization) should continue to improve off of the August nadir, but with some underlying market stability as a necessary precursor to this.

Figure 13. SMID IPO Count by Month (YTD)



Source: Bloomberg

Appendix 1: SMID M&A Deals Since August

Figure 14. SMID M&A Deals Announced Since August

Target Company Name	Ticker	Index	Target Sector	Acquirer Company Name	Ticker	Index	Announced Date	(Expected) Completion Date	Deal Type	Transaction Value
PAETEC Holding Corp.	PAET	RUT	Utilities	Windstream Corp.	WIN	RMC	08/01/11	02/01/12	Strategic	\$2,237
AMAG Pharmaceuticals, Inc.	AMAG	RUT	Health Care	MSMB Capital Management LLC			08/02/11		Financial	\$304
Emdeon, Inc.	EM	RMC	Health Care	Blackstone Group LP	BX		08/04/11	12/31/11	Financial	\$3,013
Transatlantic Holdings, Inc.	TRH	RMC	Financial Services	National Indemnity Co.			08/07/11	12/31/11	Strategic	\$3,249
Renaissance Learning, Inc.	RLRN	RUT	Consumer Discretionary	Permira Advisers LLP			08/16/11	10/19/11	Financial	\$448
PharMerica Corp.	PMC	RUT	Health Care	Omnicare, Inc.	OCR	RMC	08/23/11	12/02/11	Strategic	\$700
Venoco, Inc.	VQ	RUT	Energy	Venoco, Inc. /Marquez/			08/29/11		Financial	\$1,011
Caliper Life Sciences, Inc.	CALP	RUT	Health Care	PerkinElmer, Inc.	PKI	RMC	09/08/11	12/31/11	Strategic	\$523
Global Industries Ltd.	GLBL	RUT	Energy	Technip SA	TEC		09/12/11	03/31/12	Strategic	\$1,047
Netlogic Microsystems, Inc.	NETL	RUT	Technology	Broadcom Corp.	BRCM		09/12/11	06/30/12	Strategic	\$3,352
JAKKS Pacific, Inc.	JAKK	RUT	Consumer Discretionary	Oaktree Capital Management LP			09/13/11		Financial	\$361
Goodrich Corp.	GR	RMC	Producer Durables	United Technologies Corp.	UTX		09/21/11		Strategic	\$17,842
Harleysville Group, Inc.	HGIC	RUT	Financial Services	Nationwide Mutual Insurance Co.			09/29/11	03/31/12	Strategic	\$1,630
Pharmaceutical Product Development, Inc.	PPDI	RMC	Health Care	Hellman & Friedman LLC, Pharmaceutical Product Development, Inc. /Private Group/, The Carlyle Group LLC			10/03/11	12/31/11	Financial	\$3,416
Complete Production Services, Inc.	CPX	RUT	Energy	Superior Energy Services, Inc.	SPN	RMC	10/10/11	12/31/11	Strategic	\$3,088
99c Only Stores	NDN	RUT	Consumer Discretionary	99c Only Stores /Private Group/, Ares Partners Management Co. LLC, Canada Pension Plan Investment Board, Government of Canada			10/11/11	03/31/12	Financial	\$1,531
BigBand Networks, Inc.	BBND	RUT	Technology	Arris Group, Inc.	ARRS	RUT	10/11/11	12/31/11	Strategic	\$138
El Paso Corp.	EP	RMC	Energy	Kinder Morgan, Inc.	KMI		10/16/11	06/30/12	Strategic	\$33,909
Brigham Exploration Co.	BEXP	RUT	Energy	Statoil ASA	STL	RUT	10/17/11	03/31/12	Strategic	\$4,520
Mac-Gray Corp.	TUC	RUT	Producer Durables	KP Capital LLC			10/24/11		Financial	\$237
HealthSpring, Inc.	HS	RUT	Health Care	CIGNA Corp.	CI	RMC	10/24/11	06/30/12	Strategic	\$3,811
RightNow Technologies, Inc.	RNOW	RUT	Technology	Oracle Corp.	ORCL		10/24/11	03/31/12	Strategic	\$1,308

Source: FactSet

Appendix A-1

Analyst Certification

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