



Equity Partners for Companies Primed to Become Public®

Newsletter

2nd Quarter 2010

A Tale of Two Markets: The Glorious Decade for Small-Cap Stocks

Market pundits have declared the aughts to be “the lost decade for stocks.” And it has now become accepted gospel in the financial community. There’s only one problem with this bromide—it isn’t true for small-cap stocks. In fact, not by a long shot.

One could easily be forgiven for assuming that all stocks got trashed in the last decade...and continue to suffer. Consider the *Wall Street Journal* headline on the last day of May: “Stocks Wind Down a Brutal May”, with the explanation that: “The Dow ended down 7.9% for May, its biggest monthly drop since February 2009 and the worst percentage decline for May since 1940.” But neither the Dow nor large-cap stocks in general are representative of the entire U.S. stock market. Opportunity abounds elsewhere, particularly in small-cap stocks.

The S&P 600, a small-stock index, gained nearly 100% for the period January 1, 2000 to May 3, 2010—or a return of approxi-

mately 7.1% per year. During the same approximately 10-year period, the S&P 500 fell by nearly 18%, for a loss of approximately 2.0% per year. The Russell 2000 index, another small cap-stock index, outperformed the large-cap Russell 1000 index by nearly 50% in the last decade.

This outperformance was not the result of an outlier. Quite the contrary, small stocks outperformed large stocks in every year of the decade except for 2007, when large-cap stocks posted a modest 4.8% edge.

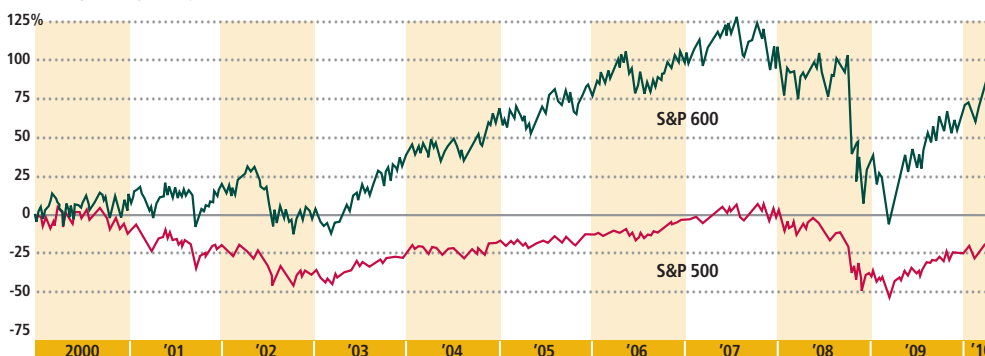
According to Ned Davis Research (www.ndr.com), it is not uncommon for small-caps to have long periods of outperformance. A *Wall Street Journal* article explained the large-cap vs. small-cap dichotomy this way: “Small caps have been so appealing in part because large caps have been so unappealing for so long.”

Small-caps tend to perform relatively better than large-cap stocks in both low interest rate environments and in economic recoveries. Thus, the category has recently been operating with two strong tail-winds.

The consensus earnings growth estimate for the S&P 600 is 130%, compared to only 42% for the S&P 500. And while the S&P 600 forward P/E ratio is higher at 22 vs. 15 for the S&P 500, the PEG (P/E to Growth rate) ratio is a very modest 0.17.

Until interest rates begin to turn, the small-cap stock rally may continue to extend the glorious decade just passed.

An Era of Small-Cap Dominance
Percentage change, daily data



Source: Capital IQ

Keating Capital, Inc. is a business development company that specializes in making pre-IPO investments in innovative, high growth companies that are committed to and capable of becoming public. We provide individual investors with the ability to participate in a unique fund that invests in a company’s late stage, pre-IPO financing round—an opportunity that has historically been reserved for institutional investors only.



Embracing the Pink OTC Market Model



Previously in this column, we had noted that in 2001 there was an average of 306 market makers quoting prices in stocks trading on the FINRA operated Over-the-Counter Bulletin Board (OTCBB). That number had dwindled to 199 at the end of 2008 and 160 at the end of 2009. As of April, the number stood at 135. There

are now some 51,127 priced market maker quotes on Pink Quote vs. 9,615 on the OTCBB.

The OTCBB is now terminally ill; the faster that FINRA pulls the plug the better.

Meanwhile, back in the land of free markets, Pink OTC Markets, Inc. (www.otcm Markets.com), the operator of the Pink Sheet quotation system, has been trail blazing a new model. Mind you, this is not your father's Pink Sheets. Much has changed, and Pink OTC Markets is now the standard bearer for over-the-counter trading in the U.S. In fact, there are only 53 issues exclusively quoted on the OTCBB with the vast majority of over-the-counter securities (80%) being quoted on Pink OTC Markets.

The company now operates the leading electronic interdealer quotation and trading system in over 9,000 securities not listed on a U.S. stock exchange. Pink OTC Markets segments these securities into three tiers: the quality controlled OTCQX marketplace, the U.S. registered and reporting OTCQB market-

place, where nearly all reporting issuers are now quoted, and the speculative Pink Sheets marketplace, where non-reporting companies are quoted. These three tiers constitute the third largest liquidity pool for trading public company shares, after the Nasdaq Stock Market and the New York Stock Exchange.

We embrace and support this model for the simple reason that we are unqualified advocates of free markets, including and especially markets for equity securities.

Pink OTC Markets is to be commended for its transparency and rational segmentation of its diverse market place. For example, in the Pink Sheets segment of the company's Web site, comprised of non-reporting companies, there is:

- ◆ A "Yield" sign to warn investors that limited information is available for 737 securities;
- ◆ A "Stop" sign to warn that no information is available for an additional 3,514 securities; and
- ◆ A skull and cross bones to further identify those 26 securities for which the display of quotes has been discontinued because of a range of questionable or suspicious activities.

Surely in this era of failed regulation and ubiquitous access to information, that is all the information necessary to help investors understand the risk profile of certain categories of publicly traded stocks.

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	Pink OTC Markets			OTC Bulletin Board
	OTCQX	OTCQB	Pink Sheets	OTCBB
Companies				
Number of Securities	105	3,815	5,416	53 (Quoted on OTCBB Only)
Quality Control Listing Process Companies meet qualitative and quantitative standards	✓	✗	✗	✗
Shells & Financially Distressed Companies Permitted	✗	✓	✓	✓
Reporting Standards	SEC, International or Alternative	SEC	SEC, International or Alternative	SEC
Trading Platform				
Electronic	✓	✓	✓	✗
FINRA Regulates Trading	✓	✓	✓	✓
Market Maker Quotes	51,127			9,615
Free Level 2 Quotes Available to Investors	✓	✓	By Subscription	By Subscription

Source: Pink OTC Markets, Inc. (as of April 5, 2010, except for Market Maker Quotes, which are as of June 3, 2010)

Keating Capital Portfolio Company News

On April 15, 2010, NeoPhotonics Corporation (www.NeoPhotonics.com) filed its plan to go public through an initial public offering of up to \$115 million of shares of its common stock on the New York Stock Exchange. J.P. Morgan Securities Inc. and Deutsche Bank Securities Inc. are acting as joint book-running managers of the offering and as representatives of the underwriters.

NeoPhotonics Corporation (www.NeoPhotonics.com) is a leading developer and vertically integrated manufacturer of photonic integrated circuit (PIC) based components, modules and subsystems for use in telecommunications networks. The company's products include active semiconductor, passive PLC and MEMS multi-dimensional switching functions in a single product. This integration is enabled by nanomaterials and nanoscale design and fabrication technologies. Backed by leading venture capital firms and institutional investors, NeoPhotonics maintains headquarters in San Jose, California



and ISO 9001: 2000 certified engineering and manufacturing facilities in Silicon Valley and Shenzhen, China.

Keating Capital's investment in NeoPhotonics' Series X Convertible Preferred Stock provides for the conversion into NeoPhotonics' common stock at a 50% discount to the IPO price. While the Series X Convertible Preferred Stock held by Keating Capital is expected to automatically convert into NeoPhotonics' common stock if the IPO is completed, these shares of common stock will be subject to a lock-up agreement which generally prohibits Keating Capital from selling such common shares for a period of six months following the completion of the IPO. There is no assurance that the NeoPhotonics' IPO will be completed or, if completed, when it may be completed.

IPO Commentary

While comparisons to 2009 remain easy, the IPO market has been resilient through the first five months of the year, particularly for smaller issuers. Consider: Through May, there has already been a total of 46 IPOs versus a total of 51 for all of 2009. Moreover, of the 46 2010 IPOs, seven issuers raised gross proceeds of \$50 million or less (compared to one for all of 2009)—a healthy sign that smaller companies can

tap the public equity markets. And unlike in 2009 where the "Final Four" (Goldman Sachs, Morgan Stanley, J.P. Morgan and Bank of America Merrill Lynch) either lead or co-managed nearly 70% of all IPOs (35 out of 51), thus far in 2010 underwriters other than the Final Four have lead or co-managed 43% (20 out of 46) of this year's crop of IPOs.

Year	IPOs (#)	Average IPO Size (MM)	Median IPO Size (MM)	IPO Size < \$50 MM (#)	Median Pre-Money (MM)	Median Net Income (MM)	Net Income < \$0 (#)
2010 YTD*	46	\$141	\$109	7	\$348	\$7	17
2009	51	\$302	\$136	1	\$418	\$14	10

Source: Capital IQ, IPO Home

* Note: Keating's IPO market analysis is through May 31, 2010 and excludes REITs, funds and reverse mergers from our calculations.

Opinion (continued from page 2)

Capital formation can only occur when investors are willing to provide speculative "risk" capital to fund new ideas and businesses. Liquidity is the grease that makes markets work efficiently and which, in the case of public issuers, can lower the cost of capital by as much as 50%.

The "flash" crash of May 6 demonstrated that there can never be enough liquidity in the marketplace. This is especially

true for the world of micro- and small-cap stocks, which provide investors with the opportunity to participate in the exciting, albeit risky, world of growth investing.

Pink OTC Markets has demonstrated clearly that its market-based approach to equity trading can and does work and is superior to any scheme crafted by regulators. As two obvious next steps, we need to get the regulators out of the world of equity research and credit ratings so that these markets can also evolve and thrive.



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Keating Capital Investment Criteria



- ◆ Later stage, \$10 million+ in revenue
- ◆ Seeking growth capital
- ◆ Profitable or EBITDA positive
- ◆ Projected 25%+ annual earnings growth
- ◆ Public listing within 18 months; exchange qualified
- ◆ Public market sizzle

Please submit business plans to Kyle Rogers: kr@KeatingInvestments.com

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