



PENNY STOCKS:
ARE THEY USEFUL FOR ANALYSTS?

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PENNY STOCK OVERVIEW - WHAT ARE THEY?

Few valuation professionals utilize information from what have become known as "Penny Stocks." These are micro-cap public companies, most all of which are traded on either (i) the Over the Counter Bulletin Board ("OTCBB") or (ii) what is known as the "Pink Sheets". Information can be scarce and difficult to trust. When it comes to these relatively thinly traded stocks the central question valuator ask is:

- Can valuator rely on the pricing mechanisms that may be gleaned from micro-cap penny stocks?
- Should they (because of low trading volume and limited or even false information) be ignored in the valuation process?

Amid all the apparent chaos and seeming investment insanity, the "investing public" appears to like the OTCBB and Pink Sheet gamble. As a result over \$50 million a year is poured into this market with few calls for regulatory change. The SEC, through its relative inaction, essentially subscribes the "buyer beware" philosophy when it comes to this segment of the market.

However, in the face of the ostensibly immeasurable investment criteria of the Pink Sheets, and to a lesser extent the OTCBB, there can be islands of sanity and reasonableness where the OTCBB's and Pink Sheet stocks compare favorably with the matrixes of listed securities on major exchanges. This paper will explore the perplexing realm of non-exchange traded stocks in an attempt to answer the primary question valuator bear in mind: Can this data be trusted?

We will begin with a summary of information on the various primary exchanges and markets as shown in the table below:

Market Statistics

July 2006

Market	Companies Listed	Share Volume	Value Traded
NYSE	3,654	35,952,003,055	\$1,306,031,000,000
Nasdaq	3,398	29,057,289,811	\$635,837,384,680 ¹
Bulletin Board	3,304	37,091,296,237	\$2,794,045,583
Pink Sheets	4,741	88,081,319,065	\$9,156,547,876

¹Value trades based on average daily volume per www.nasdaqtrader.com



“Information is the investor’s best tool when it comes to investing wisely. But accurate information about ‘micro cap stocks’ – low priced stocks issued by the smallest of companies – may be difficult to find. Many micro cap companies do not file with the SEC so it is hard for investors to get the facts about the company’s management, products, services and finances. When reliable information is scarce, fraudsters can easily spread false information about micro cap companies making profits while creating losses for unsuspecting investors.”¹

Captured subtly in the quote above, the SEC has limited interest and oversight on many of the Penny Stocks. Where does the SEC spend more of its regulatory efforts? A company must file reports with the SEC if it is:

- Listed on an exchange or the NASDAQ;
- Quoted on the OTCBB; or
- If it has 500 or more investors and \$10 million or more in assets.

The SEC reporting companies on the OTCBB have to comply with standard SEC reporting rules including quarterly reports and annual audited financial statements, normal disclosure requirements, Sarbanes-Oxley (“SOX”), etc. As we know maintaining these rules is a very expensive exercise. These rules and associated costs have driven thousands of micro cap companies to the Pink Sheets.

KEY DIFFERENCES BETWEEN OTCBB AND PINK SHEET COMPANIES

OTCBB

The OTCBB is an electronic quotation system that displays real-time quotes, last sale prices and volume information. Although the NASD oversees the OTCBB, it is not part of the NASDAQ Stock Market and therefore not subject to its more stringent rules and oversight. OTCBB companies have registered their securities with the SEC and meet its reporting requirements.

The “Pink Sheets”

Named for the color of paper on which they’ve historically been printed Pink Sheets are listings or price quotes for companies that trade in the over the counter (“OTC”) market. “Market-makers”, brokers who commit to buying and selling the securities of the OTC issuers, can use Pink Sheet information. This information is published by Pink Sheets, LLC, a private company that is unregulated by the SEC. It sets its own rules and procedures to be “listed” in the Pink Sheet system (both hard copy and electronic).

¹ “Micro Stocks: A Guide for Investors”, SEC.

The Pink Sheet companies are not required to publish company financials (and they don't), they do not require financial statements to be audited, and are not required to disclose critical company information (and they don't). Yet they are still called "public" companies. The following table summarizes key differences between active public companies including many OTCBB and the Pink Sheets.

Significant Factors that Affect Stock Prices

Active Public Stocks	Pink Sheet Stocks
<ol style="list-style-type: none"> 1. Company Financials 2. Industry Information 3. Comparable Companies 4. Public Information on Subject Company* 	<ol style="list-style-type: none"> 1. Not Available, Unaudited 2. Not Available 3. Not available 4. Public Information on Subject Company**

* Subject company press releases, messages boards, blogs, and industry analysts

** There are few or no industry analysts following pink sheet companies

As discussed earlier, and as fundamental to valuation analysts, accurate and complete information about public companies is critical to make wise investment decisions. This information directly affects stock prices. How then does an investor obtain additional information about Pink Sheets other than the actual trading price and price history? Answer: Blogs and message boards.

Incredibly, lots of people actually use this information (or misinformation as it often turns out to be) to influence their investment decisions. These companies have no published financials, little or no company investment, and no industry comparables, if such a thing was possible. Yet they still buy billions of dollars of Pink Sheet stocks a year.

SEC Rules for Pink Sheet companies

Although relatively scant there are some rules and regulations for Pink Sheet companies. This revolves primarily around what is known as a Reg. D exemption. Pink Sheets are exempt from the Securities Act of 1933 by filing a Reg. D exemption. They do not have to register with the SEC and all its voluminous rules and filing requirements. Reg. D is a brief notice that includes the names of the company owners and stock promoters, but contains little other information about the company.

Reg. D has three exemptions from registration of the securities:

- **Rule 504** - is of special interest for very small Pink Sheet companies. Rule 504 provides exemption for the offer and sale of up to \$1,000,000 of securities in a 12 month period. The company can not solicit or advertise for investors, but can find an accredited investor and do a deal and let the investor buy, without any disclosure to the public. This private sale must be unrestricted stock. It can be like a line of credit for a Pink Sheet company. For example, these deals are nearly always at large discounts to the publicly quoted prices. One private deal I am aware of called for a 40% discount to the close price of the previous day. The investor could sell his stock potentially the next day - totally unrestricted.
- **Rule 505** - provides an exemption for larger transactions (up to \$5 million) with accredited investors but requires the company to provide audited financials and the company must answer questions by prospective purchasers. Also, the securities they receive are "restricted" for a year and may not sell without registration.
- **Rule 506** - is a "safe harbor" for a private offering exemption. This is for larger deals (unlimited amount of capital). Again, no general solicitation or advertising to market the securities. You can include up to 35 non-accredited investors, but they must be sophisticated, i.e., have sufficient knowledge and experience in financial matters to make them capable to evaluate the merits and risks of the prospective investment.

In addition to the federal securities laws, companies have to comply with state securities laws.

PENNY STOCK MANIPULATION

The penny stocks historically have been subject to two major price manipulations: (i) “pump and dump” schemes and (ii) naked shorts.

First, the naked shorts in the world of penny stocks’ “market makers”. Here it is well known that some of the less reputable market makers will execute naked short selling putting downward pressure on the stock price and then cover the short with lower priced replacement stock. With very thinly traded stock, this form of manipulation can have significant negative price impacts.

A more well known scam is the pump & dump scheme offer - securing a substantial position in the security. The scammers send out unsupported information, over enthusiastic sales pitches, and sometimes downright lies about the company. After releasing sometimes millions of scam propaganda, the price of these thinly traded stocks can double, triple or more. After the price has risen substantially, the scammers sell their stock and stop touting it. Some may execute naked shorts to maximize their profits.

A recent Kiplinger article hit home regarding the problem with penny stocks. The article supports the idea that many investors believe penny stocks are opportunities for quick and easy profit. *“But in reality, penny stocks are more of a swampland. And now, thanks for spam, the muck is spreading and efforts to stop it have so far been as effective as ordering the tide not to come in”.*² The SEC estimates that 100 million stock-spam messages are sent daily.

The pump & dump schemes can be stopped as evidenced from the removal of previous egregious penny stock scams in the Vancouver Stock Exchange. The Canadians cleaned up with new rules and aggressive crackdowns on violations. As a consequence the scammers have moved to the U.S. An estimated 660 companies from British Columbia are now quoted on the OTCBB and the Pink Sheets but don’t trade on a Canadian exchange.

Even though most spammers are operating illegally, prosecuting them isn’t likely. *“For a promoter’s claim to run afoul of the SEC, the law states that a “reasonable” person would have to believe a touter’s claims are true.. But because most reasonable people don’t believe the claims, the law doesn’t view many of these assertions as illegal...”*³

In response what is the SEC’s “big club”? Answer: a 10 day suspension of trading.

² Kiplinger’s Personal Finance, June 2007. “The Truth behind Penny Stock Spam.”

³ Ibid.

Another proposed regulatory effort by Chief Executive of the Pink Sheets, Cromwell “Do Good” Coulson, is a plan to label Pink Sheet stocks suspected of being involved with pump and dump schemes with a skull and crossbones on the Pink Sheet Website. Honest, I am not making this up.

The bottom line is the SEC does not have the manpower (2 investigators I am told for approximately 8,000 stocks in this market) nor does Congress apparently have the will to help investors. It operates on the premise that since you bought a Pink Sheet stock with limited data and no financials, you are warned that it’s your problem and your crap shoot. In light of this information, we circle back to our original question: is data from Penny Stocks useful for valuation analysts? The answer, surprisingly, is yes.

BANK INDUSTRY ANALYSIS

Question: Are there segments of the OTCBB and the Pink Sheets that can be helpful to analysts? Unfortunately the broad brushed answer in most segments is no. However, I investigated one such segment where the answer was different.

Historically, small local and regional banks have been viable securities for many investors – primarily from that town or region. I analyzed the OTCBB and Pink Sheet banks summarized on Yahoo Finance’s Midwest Bank Industry screen. There were 105 companies in the total population of Midwest Banks. I then sorted this population into the following categories:

- OTCBB & Pink Sheets with Market Capitalization under \$50M, \$50M to \$100M, and over \$100 M.
- NASDAQ traded bank sheets over \$100 MM Market Capitalization.
- Exchange Traded Companies.

I chose the following matrixes for comparison: (i) Market Cap, (ii) P/E Ratio, (iii) ROE, (iv) Dividend Yield, and (v) Price to Book Ratios. Note that outliers were deleted, i.e., a stock with a 500 P/E is eliminated. The following is a summary of the results:

Category	P/E	ROE	Div. Yield	Price/Book	Exhibit
Exc. Traded	12.6	15.1%	3.8%	1.87	I
NASDAQ	15.5	11.9%	3.2%	1.68	II
OTCBB/Pink Sheets					
-Over \$100M	18.3	11.4%	3.7%	1.84	III
-\$50M to \$100 M	16.7	8.4%	2.9%	1.28	IV
-Under \$50M	14.7	10.4%	3.1%	1.46	V

The results were surprising. The over \$100 M Market Cap, OTCBB & Pink Sheet companies actually trade at improved multiples to the NASDAQ average multiples: higher P/E, slightly higher yield (3.7% versus 3.2%) and a higher price to book ratio 1.84 to 1.68 times. In fact, the over \$100MM OTCBB & Pink Sheet companies trade favorably to the exchange traded bank stocks with a higher P/E of 18.3 versus 12.6 for the exchange traded.

The \$50M to \$100M Market Cap firms have a different picture trading at a favorable P/E to the exchange traded and NASDAQ (16.7x versus 12/6x and 15.5 respectively). The dividend yield is slightly lower for this OTCBB Pink Sheet category and the Price/Book ratio is 1.28 times versus 1.87 and 1.68 times for the exchange traded and NASDAQ bank stocks.

Finally, the super micro cap (under \$50M Market Cap) was the most surprising of all, in my opinion. The P/E ratio averages between the exchange traded and the NASDAQ bank stocks, even though the yield was slightly less, the ROE was lower on average at 10.4% and the price to book ratio for this OTCBB/Pink Sheet category is 1.46 versus 1.87 and 1.68 of exchange traded and NASDAQ company average.

What is the takeaway from this?

The small “publicly traded” bank stocks generally traded at little or no discounts to the much larger multi billion dollar exchange traded stocks. In fact, the over \$100M Market Cap generally traded at improved multiples to those much larger companies.

CONCLUSION

In summary, the OTC Bulletin Board companies have much more stringent requirements than Pink Sheet companies. Both, however, have little if any SEC effective oversight. Even with SEC registration and audited financials, the OTCBB companies typically have very small floats and are subject to stock price manipulation. These companies receive calls from “entrepreneurs” who will agree to “assist” you in promoting the value of your company’s stock in exchange for a percentage of the shares outstanding.

The Pink Sheet companies are truly the wild west of public companies. Little, if any, SEC oversight exists. This is a buyer beware world with no audited financials, no financial reporting, no verification of asset ownership. The rumor mill drives most of the information. Insiders can (and do) buy and sell large quantities of shares. They can issue special classes of stock to benefit or enhance their own positions without shareholder approval. Management provides little information to the public. They feather the nest of accredited investors by diluting the current shareholders with sales of readily available marketable shares at 40%+ discounts to the latest prices.

OTCBB and Pink Sheet companies have many concerned investor groups that are demanding more regulation, but for every detractor someone sings another song. For example, the spokesman for the micro cap company, Political Alliance Corp. and the National Small Public Company Leadership Council said, *“There are thousands of micro cap Pink Sheet and OTCBB companies out there are creating the jobs and the potentially new products and technologies in our economy and it’s time for our federal government to acknowledge this fact and begin to help these firms thrive and grow in 2006 by reforming harmful and unfair government regulations.”*

What regulations? I found few for the Pink Sheets companies. It truly is buyer beware. There are exceptions to every rule. The Pink Sheet bank stocks seem to have reasonable pricing for the securities and may be used by analysts.

Exhibit I						
Exchange Traded Market Cap						
	Market Cap	P/E	ROE	Div. Yield	Price to Book Value	
CBC	499.6M	11.4	12.77	3.30		1.35
CMA	9.8B	11.36	14.96	4.00		1.91
IFC	482.3M	337.92	7.17	3.00		0.94
MBR	130.3M	12.66	10.74	1.60		1.29
NCC	23.7B	10.07	16.91	4.10		1.63
ONB	1.2B	15.32	12.28	4.80		1.90
PRK	1.3B	13.84	15.15	4.00		2.01
USB	59.8B	13.19	23.03	4.60		3.02
Averages		12.55	15.12	3.77		1.87

IFC figures not included in averages

Exhibit II

NASDAQ Over \$100M Market Cap

	Market Cap	P/E	ROE	Div. Yield	Price to Book Value
ASBC	4.2B	13.84	13.86	3.50	1.89
TRUE	124.6M	16.09	6.03	2.50	1.06
CITZ	165.6M	31.90	3.90	3.20	1.26
CHFC	697.5M	15.90	8.61	4.00	1.35
CHEV	128.2M	73.83	2.31	2.40	1.75
CRBC	1.6B	14.45	5.72	5.30	1.03
CORS	955.1M	5.17	24.69	5.80	1.13
DEAR	141.1M	15.68	6.47	0.00	0.97
FITB	22.3B	18.81	12.16	4.20	2.23
BUSE	443.2M	14.87	16.57	3.50	2.36
FFBC	614.7M	29.22	7.27	4.10	2.16
THFF	405.9M	17.33	8.71	2.70	1.50
FRME	444.8M	14.69	9.43	3.80	1.35
FMBI	1.8B	15.31	18.11	3.30	2.42
FPFC	372.1M	14.45	8.42	2.90	1.13
FBMI	126.5M	12.58	10.77	4.50	1.31
FMER	1.6B	17.17	10.65	5.60	1.92
GABC	148.1M	14.46	11.71	4.10	1.60
HBAN	5.2B	11.47	16.55	4.80	1.72
IBCP	386.3M	11.84	13.36	4.40	1.50
IBNK	400.7M	19.75	8.82	2.90	1.68
LKFN	275.2M	14.98	14.93	2.40	2.04
MCBC	267.8M	13.91	12.60	3.10	1.64
MSFG	318.6M	13.13	10.74	3.10	1.20
MBWM	234.0M	12.28	11.48	2.00	1.33
MBHI	422.2M	22.92	7.05	3.00	1.47
NTRS	14.1B	20.72	17.79	1.50	3.49
OAKF	129.3M	15.18	9.30	3.50	1.39
OVBC	105.3M	19.59	3.02	2.90	1.73
OSBC	387.8M	16.91	15.22	1.90	2.45
PEBO	273.3M	12.92	11.34	3.30	1.40
PNBC	101.2M	15.83	10.10	3.60	1.55
PVTB	726.7M	18.73	14.13	0.90	2.83
SKYF	3.2B	15.76	11.08	3.70	1.68
TAYC	402.6M	8.72	18.82	1.10	1.49
WTFC	1.1B	17.67	9.49	0.70	1.49
SRCE	533.2M	13.77	11.00	2.30	1.46
Averages		15.49	11.85	3.18	1.68

CITZ, CHEV and OVBC figures not included in Averages

Exhibit III

OTCBB & Pink Sheet Market Cap Over \$100M

	Market Cap	P/E	ROE	Div. Yield	Price to Book Value
BYLK.OB	117.1M	15.82	9.18	4.30	1.42
FMNB.OB	136.9M	18.92	9.49	6.10	1.80
FMBH.OB	174.2M	17.96	13.52	1.30	2.31
MSTI.OB	321.1M	17.00	13.08	3.10	2.13
MMBI.OB	102.5M	25.97	4.26	2.60	1.09
UBMI.OB	117.4M	13.90	11.79	3.60	1.56
Averages		18.26	11.41	3.68	1.84

MMBI figures not included in Averages

Exhibit IV

OTCBB & Pink Sheet \$50-100M Market Cap

	Market Cap	P/E	ROE	Div. Yield	Price to Book Value
AJSB.OB	53.4M	58.69	3.20	1.70	1.86
COFS.OB	53.3M	15.13	5.70	4.10	1.04
CLDB.OB	85.7M	18.59	9.25	4.80	1.69
CHBH.OB	71.0M	13.18	10.86	3.20	1.39
DCBF.OB	91.9M	12.83	12.50	2.20	1.53
FETM.OB	64.3M	12.03	10.81	3.40	1.25
FNHM.OB	76.1M	14.22	11.23	3.40	1.54
HLAN.OB	55.8M	13.73	12.11	3.00	1.57
KLIB.OB	71.2M	13.71	13.71	2.30	1.82
MWFS.OB	54.9M	50.45	3.06	2.60	1.61
OKFC.OB	99.5M	14.18	11.11	2.20	1.51
OXBC.OB	61.2M	19.02	6.59	2.30	1.23
Averages		14.66	10.39	3.09	1.46

***ASJB and MWFS figures not included in Averages*

Exhibit V

OTCBB & Pink Sheet Market Cap Under 50M Market Cap

	Market Cap	P/E	ROE	Div. Yield	Price to Book Value
ASFE.OB	17.9M	17.85	7.26	1.20	1.26
CMOH.OB	30.5M	17.36	8.10	2.90	1.37
CSBB.OB	44.1M	14.58	8.86	4.00	1.28
DSFN.OB	21.1M	31.53	3.81	3.30	1.24
HCFL.OB	13.3M	16.97	5.80	2.80	0.96
MSVB.OB	28.6M	29.25	5.93	2.70	1.70
PVLN.OB	32.8M	13.81	8.84	2.20	1.17
PSBG.OB	48.0M	16.53	6.61	4.70	1.08
PSBQ.OB	43.0M	13.09	9.80	2.40	1.25
SOMC.OB	40.1M	10.55	14.69	3.40	1.41
TSEO.OB	14.0M	41.26	3.74	2.50	1.54
Averages		16.67	8.43	2.92	1.28

***DSFN and TSEO figures not included in Averages*