

## Cover story



# Independents' day

**As Arindam Nag reports, sell-side research will soon feel the heat from the growing independent research industry**

**T**he independent equity research industry may be at an early stage of growth but there are already signs it will take the shine off sell-side equity research.

Regulatory changes on both sides of the Atlantic are helping raise the profile of independent research. Similarly, the layoff of scores of sell-side analysts in recent years is spawning an industry that will soon be a force to be reckoned with.

In the US, home to the biggest stock market in the world, the number of independent research firms more than trebled between 2001 and 2004 to 425, according to US equity research consulting firm Integrity Research Associates, a Connecticut-based inde-

pendent research company. Europe has witnessed a similar rise with the total number of firms now pegged at around 350, according to Eden Financial, a London-based brokerage firm.

Independent research that focuses on equities has historically lurked around Wall Street but the concept is newer in Europe, where independent companies have traditionally tended to concentrate on areas like macroeconomics and strategy. But now firms such as Clear Capital (see *Research revolution*, page 28), Objective Capital and Independent Minds in the UK, Osaketieto in Finland and Redeye in Sweden are picking up buy-side customers.

This year saw the launch of an organization called Euro IRP to bring together independent research providers that sell their goods directly to the buy side. So far there are 15 members. 'Independent research is quite fragmented [in Europe] because the whole sector is at an early stage,' says Hans Plugge, senior account manager at Independent Minds and director of Euro IRP.

'The profile of an independent research firm is now

solidifying. It is becoming cast in bronze as a permanent feature in the marketplace,' adds Jamie Stewart, head of institutional marketing and research at Eden Financial.

The buy side is getting hungrier for this research – and its appetite is expected to increase further. 'The big shift we are seeing is where institutions are increasing their budgets to build internal research teams, paying for more independent research but paying less for sell-side research,' points out Michael Mayhew, head of Integrity Research Associates.

Ongoing regulatory changes further support a boom in independent equity research. In the UK the unbundling of soft commissions paid by institutions to brokerage firms is the main driver of this trend. Two thirds of UK fund managers say they are cutting the number of brokers and the amount of brokerage research they use as a result of the requirement to separate out commissions paid for different brokerage services, according to a recent study by Greenwich Associates. This study further shows that 70 percent of fund managers plan to increase their use of independent research.

US regulators are closely watching how unbundling pans out in the UK, and may devise similar rules. Stateside buy-side firms may also follow Fidelity Investments' lead and voluntarily unbundle fees paid to brokerage firms. In Fidelity's case, it's separating trading and research costs paid to Lehman Brothers and Deutsche Bank.

### Revenue streams

So far there are two business models for this research. Some research firms are choosing sectors and companies they want to cover and selling their research directly to individual and institutional investors. The other group is producing paid-for or corporate-sponsored research. Clients of companies in this group are under-covered firms that pay for the research company to either commission out or produce research that is then distributed through various channels (see *Paying to play*, page 26).

London-based Objective Capital, which belongs to the latter group, opened for business a year ago and now has analysts writing reports on 20 companies. 'Our job is to create liquidity for the stock and to detail the strengths and weaknesses of a business,' says Gabriel Didham, chief executive of Objective Capital.

According to Didham's business model, the sponsoring companies pay up to £20,000 (\$35,000) for guaranteed research for a fixed period. Objective Capital chooses analysts to produce the research. Companies cannot dictate the choice of analyst or discuss details of anything material

to the company's future performance that has not been widely disclosed. Research is distributed free to more than 10,000 financial institutions and high-net-worth individuals who may choose to invest in the stock.

Unlike brokerage analysts, Objective Capital does not stamp a buy, sell or hold rating on stocks but instead talks about the valuation of the company. It goes into details of valuation, such as cost of capital. 'We worry more about the quality of the report than the analyst's opinion,' explains Didham.

### Will the sell side survive?

With a growing trend toward buy-side firms spending on independent research, some are questioning the future of sell-side research. Integrity Research has studied the revenue model for investment banking research and questions its long-term viability. Big banks have already cut down their spending on research following the global settlement in 2003 that split banking and research arms. In 2004

### Big banks' spending on independent research

Under the 2003 global settlement, major Wall Street banks have to purchase independent research from third parties at a cost of \$432.5 mn over five years.

Firm	Amount (\$ mn)
Merrill Lynch	75.0
Morgan Stanley	75.0
Salomon Smith Barney	75.0
Credit Suisse First Boston	50.0
Goldman Sachs	50.0
Bear Stearns	25.0
JP Morgan	25.0
Lehman Brothers	25.0
UBS	25.0
Piper Jaffray	7.5
Total	432.5

Source: SEC

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sell-side companies spent around \$7.2 bn on research compared with \$10.3 bn in 2000, according to Integrity Research.

The Integrity study further shows that the cost structure of sell-side research is very high compared with independent or buy-side research. It finds the average cost (including

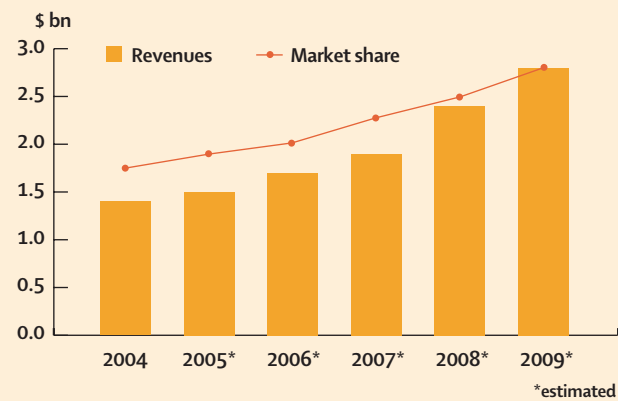
analyst salaries, bonuses, technology, market data and other overheads) per company under coverage is approximately \$175,000 per annum for investment banks and brokerage firms compared with \$10,000 for independent and buy-side companies.

'Sell-side firms need to continue to rein in their research costs and find a way to turn around the recent decline in research revenues. In the absence of this, we believe the long-term financial viability of Wall Street equity research is severely threatened,' the study concludes.

More and more sell-side firms appear to be struggling to hold on to their research arms: Dutch bank FBS Bankiers, Belgium's Puilaetco and German bank Bankgesellschaft Berlin, for example, have all pulled out of equity research. Bridgewell Securities bought Robert W Baird's European operations, and Nordea Securities decided to outsource its research to Standard & Poor's in 2004. In the US, Wells Fargo exited the equity research business in August 2005, while JP Morgan and Morgan Stanley have each merged their equity and fixed income research arms.

### Paying for independent views

Independent research revenues and market share forecast estimates



### Kicking tires

Stewart says analysts at sell-side firms will have to move away from the template style and write more insightful research. Indeed, what has been making independent research stand out among fund managers is its depth and innovation, two qualities that win favor among hedge funds that have increasingly been dominating global stock markets in the last couple of years.

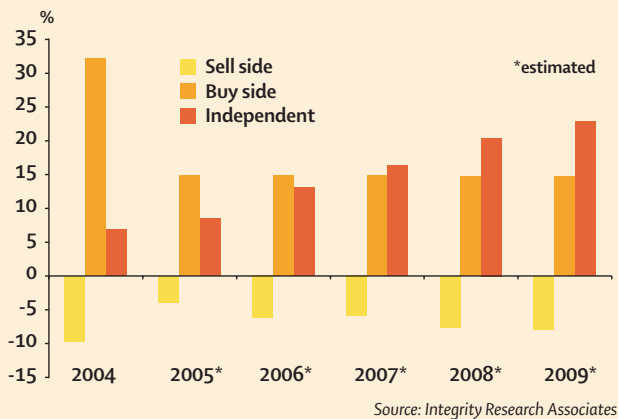
One independent firm providing innovative research is New York-based Criterion Research, founded by Neil Baron, a former fixed income analyst with Fitch Ratings. Criterion's research model tracks various accrual items, such as receivables and payables, and liabilities like leases to make an educated estimate of a company's ability to maintain its forecast earnings.

Every quarter some companies are showing higher accruals while others are reducing theirs. Hedge funds, which follow long-short strategies, have started buying Criterion's model, which has been back-tested over nearly two decades of data. Today Criterion Research has around 45 clients – including such Wall Street biggies as Fidelity and Lord Abbett.

One issue independent research firms selling directly to the buy side face is that it takes a long time to sign up institutions: Baron says Fidelity took nine months before it accepted Criterion's research. 'But with more Wall Street firms shedding analysts, the demand for independent research can only increase,' he predicts. ■

### Power shift

A recent study by Integrity Research forecasts a steady growth in expenditures on independent research in the US market



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In the heady days of the dotcom boom, a company didn't need to have a proven track record to get the attention of sell-side analysts – remember Priceline.com? Today, however, the combination of a recent bear market and a shakeup in the revenue model for investment banking research has led to some hidden gems remaining hidden.

'What was once an over-abundance of mediocre research is becoming a scarcity [of sell-side research],' points out Jeff Diermeier, former CIO at UBS Global Asset Management and current CEO of CFA Institute.

According to Reuters, sell-side coverage has been dropped on 666 out of a total of 4,075 companies in its database. Paid-for research is widely viewed as a possible solution to the dearth of banking coverage.

French regulator Autorité des marchés financiers (AMF) is proposing that this research could play a key role in stimulating coverage for small and mid-cap companies. In the US the Independent Research Network (IRN), the National Research Exchange (NRE) and the Shareholders Research Alliance (SRA) are advocating paid-for research as a way for lightly covered or completely uncov-

# Paying to play

**As Adrienne Baker finds, paid-for research may be the solution to a lack of sell side coverage – as long as investors use it**



ered companies to gain visibility. In October US state and federal authorities gave the green light to paid-for models such as IRN's by giving these firms the go-ahead to sign-up research providers.

IRN is a partnership between Nasdaq and Reuters that will match companies with analysts using a 'blind pool' whereby the company doesn't know who is writing the research. 'The [firms] will go in with their eyes open because it's objective,' says Daniel Blank, CEO of IRN. To ensure the objectivity of the research and resolve any conflicts between issuers and providers, IRN has formed an independent council.

Providers will distribute this research through their existing networks, and it will also be circulated through Reuters' platform and IRN's web site. The price to companies is not finalized but could cost more than \$100,000 a year with a minimum two-year contract. Blank says IRN has attracted a significant amount of interest from companies and is in talks with IROs, CEOs and CFOs, all eager to sign up. The organization is now in the process of signing up research providers.

Of course, the ultimate test for paid-for research is whether the buy side uses it. While at UBS, Diermeier says there was always a question mark over corporate-sponsored research. 'We looked at a lot of independent research and we were looking for experts who could address hypotheses on companies we were looking at,' he notes. But the motivation for the research was carefully scrutinized, Diermeier adds. 'The job of our analysts was to seek people out to up their game,' he explains. 'Would that be company-sponsored research? Probably not.'

Still, Blank says IRN has received positive feedback from the buy side. 'It understands the difference in what we are doing,' he points out. 'It understands that the lack of research comes from a lack of funding and you can see that it is being provided mostly to the larger companies because commissions are driving research. Our model tries to find a safe way to transfer some of the cost without sacrificing the research on the other end. ■'

