

Sell-side SUSPECTS

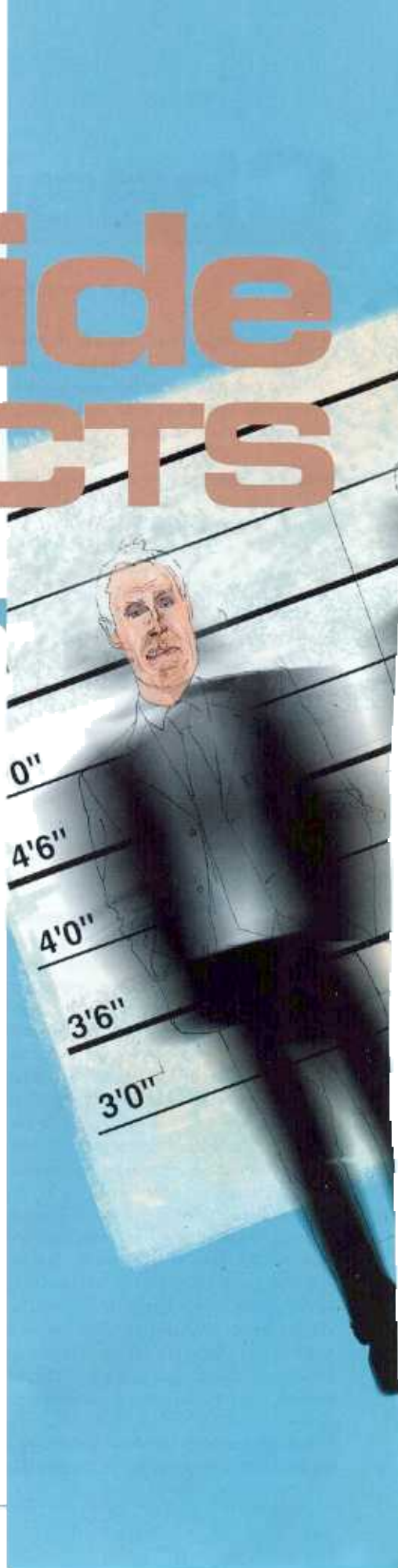
A tarnished image, layoffs, an impending global settlement and an uncertain future. *Adrienne Baker* reports on changes on the sell side

Oliver Stone should remake his 1987 film *Wall Street*, but instead of a broker's rise and fall in the world of insider trading, he should follow the roller-coaster ride of a star sell-side analyst over the last five years. From guru to alleged criminal – this stuff is better than fiction.

Senior executives of public companies that were once the darlings of Wall Street were not the only high rollers of corporate America to fall from grace in 2002. Former star analysts like Salomon Smith Barney's Jack Grubman now stand accused of hyping stocks that had banking relationships with their firms in exchange for hefty cash bonuses and other favors like, in Grubman's case, entry to an ivy league nursery school for his two children.

Scandal, it seems, is not restricted to the corner offices of WorldCom and Enron. It's pervasive among sell-side firms that put pressure on their research departments to inflate ratings on stocks with which they have (or wanted to have) banking deals. Some also dangled shares of hot IPO stocks in the faces of CEOs they wanted to do banking business with, a practice called spinning.

Criticism of the way the sell side operates culminated with New York Attorney General Eliot Spitzer's investigation of major Wall Street firms like Merrill Lynch. According to Spitzer, the economic structure of sell-side research is inherently corrupt. Beginning in April 2002, securities regulators (the SEC, the North American Securities Administrators Association, the NYSE and the NASD along with state securities regulators) joined Spitzer to investigate the relationship between investment banking and sell-side research.





At the time of writing this article, securities regulators and Spitzer are negotiating a global settlement with ten major sell-side companies that aims to restructure the revenue model for sell-side research and provide individual investors with access to objective research. Here's what they hope for: the complete separation of investment banking from research departments; a ban on IPO spinning; the funding of independent research by these sell-side firms which will then make it available to retail investors; the disclosure of analyst recommendations; and hefty fines.

Given that sell-side analysts have always been a key investor relations audience, traditionally serving as a conduit to investors, IROs are curious to see what happens. 'Their position and influence in the market will definitely change,' predicts Rick Barazza, senior vice president of investor relations at California-based Calpine.

While the fine details of the final settlement remain unknown, it's clear that it will radically alter the world of sell-side research, which is already struggling under

the weight of lower trading volume and fewer investment banking dollars. JP Mark, head of independent research firm Farmhouse Equity Research, explains that without the revenue stream of investment banking fees, sell-side firms won't have much incentive to provide research. 'If sell-side firms are forced to uncouple the relationship between investment banking and research, and analysts cannot participate in any sort of compensation from banking, it means research becomes pure overhead,' Mark says.

Before the marriage of banking and research, sell-side firms funded research entirely through brokerage commissions. But when commission margins started shrinking and stock price spreads narrowed, it made more sense to divert banking fees, which were indeed fat during the internet boom, to pay for research. Now the revenue model for research remains uncertain.

Shrinking sell side

The basic economics of the Street are about to change and will likely bring additional declines in analyst coverage, especially for small and mid-cap companies. Small caps obviously don't generate the same trading volume as large-cap companies so they have always had trouble getting sell-side coverage unless they are in a banking relationship.

With major Wall Street companies laying off analysts and investment banking separating from research, it's even less likely that small-cap companies will get attention. (In October 2002, Credit Suisse First Boston fired 20 percent of its analysts, according to the *Wall Street Journal*.)

'It will be interesting to see what happens to the sell-side community as the market is obviously going through some very tough times and these banks may not be able to maintain the staff,' says Spencer Sias, director of corporate communications and IR at California-based Varian Medical Systems.

The global settlement is expected to result in more downsizing of research departments and that will have two logical results, explains John Lewis, president of Valuation Technologies: 'Either the analysts who remain will cover more companies, or fewer companies will get covered.'

Both results are already showing. The total number of stocks followed by sell-side analysts dropped by 10 percent in the year up to August 2002, according to SecuritiesSleuth.com. Sell-side analysts are also taking on more coverage, in some cases doubling the number of companies they research. Glenn Engel, an airline analyst with Goldman Sachs, is picking up coverage of the aerospace industry and will go from watching 14 companies to covering 28 companies in two sectors. How will analysts double their workload and maintain the quality of their research? 'I don't know,' confesses Engel. 'I have been covering airlines for 18 years, so I am pretty efficient. But as for the aerospace side, I will have to adopt another strategy.' He adds that his situation is not necessarily typical of sell-side analysts today but not uncommon either.

Investor relations officers are conscious that they may lose (or already have lost) coverage from the sell side. Dave Dragics, director of IR for Virginia-based CACI International, has warned his management team to expect fewer analysts covering the company because funding for research will soon be driven by average daily volume of the stock. 'We have 14 firms covering us and we trade 370,000 shares a day; those numbers don't work. Unless the sell side decides that some of the larger daily traded volume stocks will

subsidize the lesser daily traded volume stocks, coverage will be lost.

Calpine's Barazza says two big names, Bank of America and Credit Suisse First Boston, have discontinued coverage of his power company. Analysts have left those companies and have yet to be replaced or their coverage of Calpine reinitiated by other analysts, explains Barazza. Still, Calpine has ongoing coverage from around 16 sell-side analysts.

Even larger, household names like the Dial Corporation are losing coverage. 'It's dropped off for us too,' says Stephen Blum, senior vice president of investor relations at Dial. 'There has been restructuring at firms and it takes a while for a new analyst to come on and some firms never replace the coverage.'

Losing ground

The IR world seems resigned to decreased sell-side coverage, but there's no panic. IROs haven't been relying so much on the sell side to reach the buy side anyway. Constance Bienfait, executive director of corporate communications at Kos Pharmaceuticals, a Florida-based small cap, doesn't think a drop in sell-side coverage will have a dramatic effect on her ability to attract shareholders. 'My focus is on the buy side because they make the decisions and they are taking the sell side to task and doing their own homework.' Calpine's Barazza agrees, saying he 'questions how much the buy side uses these guys [sell-side analysts]; they [on the buy side] really do their own research and we give them as much time as they need because they make the decisions.'

According to a Greenwich Associates study from May 2002, the buy side is hiring more in-house analysts and meeting with senior management more often. Institutions increased the average number of buy-side analysts on staff from 7.6 in 2001 to 8.3 in 2002. During 2001, institutional analysts had contact with management an average of 8.2 times versus 11.2 times in 2002. The buy side's reliance on in-house and independent research has been increasing for 'a lot longer than people realize,' says Bienfait. 'Good buy-side institutions haven't been using the sell side,' she adds.

CACI's Dragics comments, 'The buy side do their own research which they don't publish and they go to the sell side to verify their own thinking and get their views on the sector. That's why when you go to the buy side with a sell-side analyst, they ask the analyst to wait outside while you meet with them.'

'What I hear from the buy side is that they are doing more work because the analysis from the sell side is either not complete or in-depth enough. The sell side has a herd mentality,' says Kim Pulliam, senior vice president of investor and public relations at AmeriCredit. 'The sell side is being very cautious to the point where the research is not as thorough as the buy side wants,' adds Pulliam. In the future, Bienfait predicts, 'Companies will not be poorly received by the buy side if they have little or no coverage from the sell side.'

'Most buy-siders, if you ask them candidly what they think of sell-side research, say it isn't worth the paper it's written on; they view it as primary research,' says Vincent Catalano, president and chief strategist of iViewResearch, an independent research firm that specializes in e-business companies. 'The buy side takes information from several sources and aggregates it to come up with their own buy and sell decisions.'

The IR community has long known of the buy side's subtle disdain for sell-side research. 'There has been a trend in which IROs have started increasing their focus on the buy side and the global



[From top to bottom]
Dave Dragics,
Stephen Blum,
Rick Barazza,
and Jay Reingold

settlement propels that even more,' says John Nesbett, managing director of Lippert/Heilshorn & Associates. According to Nesbett, it will be increasingly important to have direct relations with buy-side portfolio managers because the recommendations coming out of the sell side are more likely to be negative.

Sure enough, in the wake of a new SEC rule last September requiring securities firms to explain their rating systems and use rating terms according to their real meaning, the number of sell recommendations have been 'increasing dramatically,' confirms Chuck Hill, director of research for First Call. Sell-siders also have to announce the percentage of all ratings that they have assigned to each rating category (buy, hold or sell) and disclose the number of investment banking clients in each category. At the beginning of 2002, the number of sell recommendations was around 2 percent and now it's at 10 percent, says Hill. 'Almost half of the major firms are in double digit territory - over 15 percent - and the other half of the majors are at 0-6 percent, with a couple in the middle.'

The fact is that investor relations professionals and buy-side investors have always known that sell-side research was tainted by its relationship with investment banking. The only ones in the dark, as Spitzer points out, were individual investors who took sell-side recommendations at face value. 'Everyone knew the sell side was jaded,' agrees Dragics. When CACI was looking at a secondary offering 18 months ago, the company met with a large investment bank that offered three years of sell-side coverage in exchange for a banking deal. 'There were three bankers and a sell-side analyst and they said we would be out of the gate with a strong buy - and the analyst was sitting right there,' he recounts. 'Obviously we didn't do business with that firm - it was that blatant. I wonder if it is still taking place.'

Brave new world

Beaten down by regulators and Spitzer, the sell side may be moving to yet another extreme. 'We talked to a sell-side analyst yesterday who told us that for him and his assistant to meet with a company, they had to go through three levels of compliance within their firm because of the [impending] global settlement,' recounts Dragics.

The future status of sell-side research is



hard to predict today. Despite its inherent weaknesses, the buy side and the investor relations community continue to value sell-side research. Even though they are doing more in-house research, buy-side portfolio managers still ask IROs like Dragics for names of sell-side analysts who follow the company the closest. IR professionals are still targeting sell-side analysts and some are cheerleaders of the research they provide.

'There isn't an analyst who follows us who should be put in the same class [sell-side analysts under investigation] and who hasn't provided anything but excellent research – and not everybody has a buy on me,' Dial's Blum claims.

John Nesbett contends that institutional-grade companies – meaning they have institutional holders and enough liquidity for an institution to buy them – still lean on sell-side firms to take them around from time to time, especially in the absence of a lot investment banking business.

The sell side will definitely not disappear but its role in building shareholder value is changing. The addition of independent research funded by sell-side firms and made available through their

brokerage units will certainly have an impact on how sell-side research evolves (or devolves). The question is who will provide this independent research and will it be better than what the sell side offers now?

'The obvious ones [to provide the research] are the tear sheet folks like S&P and Value Line,' says First Call's Hill. Smaller independent research boutiques probably won't want to participate in providing research because 'they have bigger fish to fry in dealing with Fidelity and the like.' Major institutions pay big bucks for independent research from small firms because it's good and it only goes to a small number of clients, Hill says. Therefore, he contends, these smaller boutiques will continue to service the buy side and it will be the larger independent firms that will step in to provide independent research.

Standard & Poor's says it will likely be involved in providing some of the independent research. 'You can expect S&P to play a big role once the settlement comes down,' says Jay Reingold, general manager of S&P's investor relations services. The firm is already noticing a trend among brokerage firms that have reduced their coverage coming to S&P to fill in the gaps for industries they no longer cover. The major consumers of S&P's equity research are retail investors who gain access to reports through their broker. 'We also have a reasonable readership among buy-side firms and investors can also access our reports though the large e-brokers or Multex.'

S&P's criteria for initiating coverage of a stock are straightforward. 'On an analytical basis, we cover the S&P 500 and beyond that there are three primary concerns,' says Reingold. 'The first is whether a company is in another S&P index like the S&P MidCap 400 or the S&P SmallCap 600. Then we look at market cap and trading volume. Our analysts also have a certain degree of discretion to pick up a stock that they feel we need to be covering. There might be a strong interest from the consumers of our research, for example; we picked up Krispy Kreme for that reason.'

It's tough to say how the quality of independent research will stack up against traditional sell-side research. After all, the number of companies big independent firms cover per analyst is considerably higher than the twelve to 20 companies typically researched by sell-side analysts. S&P, for example, has 60 analysts in the US covering



1,230 stocks. 'On average it's probably a couple more companies than your typical sell-side analyst, but then again our analysts are focused almost entirely on research,' notes Reingold. 'Sell-side analysts have many more demands on their time.'

True enough, sell-side analysts have traditionally spent a lot of time traveling to conferences and introducing companies to the buy side. Independent analysts rarely do that. Also, the retail audience for independent research clearly has different needs from the buy side. But since the idea behind the global settlement is to increase the quality of research provided to individuals, it remains to be seen whether the independent research they gain access to will be better than current sell-side reports.

Money talks

The real determining factor behind future changes in how the Street operates is money. As JP Mark of Farmhouse Equity Research points out, it's economically impossible for brokerage firms to provide research for research's sake. There has to be revenue to fund a research department, which costs a typical firm around \$500 mn a year to run.

When he was head of research at Wells Fargo, Mark tried to develop an economically sound research model by suggesting the firm sell its research to companies. The model didn't fly because his superiors thought of paid-for research as the ugly stepchild of Wall Street. Mark agrees with that perception and says, 'Most paid-for research is written by people who have no background in financial writing and are just hyping stocks.' He decided to leave his position at Wells Fargo and start his own independent research firm which targets institutional clients and focuses on small and mid-cap companies.

In the US, there are around 50 independent companies run by analysts who started their own shops and are getting paid by institutions either directly or indirectly. As Mark explains, institutions either buy the research outright or through a third party like a broker-dealer. Mark has been approached by several investor relations companies since opening for business and has initiated coverage of two companies as a result. It's possible that the one-person independent shop will become more popular in coming years as more analysts leave the sell side and purely independent

research is in higher demand.

One thing is for sure. With the revenue stream about to be cut from sell-side research, investor relations officers may have to adapt their strategy for reaching the buy side. 'When you are on the front lines of IR, the connection between investment banking and research coverage is so ingrained, it's hard to believe it could change,' says Nesbett. 'But it will make for a much cleaner interaction with the sell side. That's great because management has been forced to play this cat and mouse game for years.'

There will be more competition for coverage with fewer analysts, affirms Valuation Technologies' Lewis. And IROs 'are going to have to be smarter in knowing why a firm is likely to invest in your company and how you differ from your peers when you get in front of institutions,' he adds.

So despite what happens with the fallen all-stars of the sell side, investor relations professionals will still have their eye on the ball. Whether you are pitching to an independent analyst or a portfolio manager, it's all about differentiating your stock. There may be fewer players (and some new ones), but it's still the same game. **IR**

Counterpoint

