



US Equity Research

2005-2006 Industry Outlook

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Equity
Research

RECENT DEVELOPMENTS IN EQUITY RESEARCH

In the past few years, there have been numerous developments, including many on the regulatory front, that have had a profound impact on the equity research industry. High-profile corporate scandals and inherent conflicts of interest faced by Wall Street equity analysts have been the prime reasons for these regulatory moves. These regulations have, in turn, led to major realignments in the equity research industry. In this section, we outline the major trends and the specific developments that have impacted the various segments of the equity research industry (i.e. sell-side, buy-side, and independent research).

Sell-side

Sell-side quality: Recent developments

Sell-side research is restoring credibility

In the wake of the technology meltdown and a series of corporate scandals between 2000 and 2002, the credibility of sell-side research plummeted. During the past couple of years, Wall Street investment banks and brokerage firms have recaptured much of their credibility due to regulatory measures that have reduced obvious conflicts and forced increased transparency. This can be seen from the fact that most buy-side firms continue to value sell-side research. Buy-side confidence and acceptance of sell-side research indicates that sell-side firms are slowly restoring their credibility.

Integration of equity and credit research divisions has enhanced the quality of research

In the past couple of years, many prominent investment bankers have decided to integrate their equity and credit research departments. In November 2005, Morgan Stanley announced plans to merge its fixed-income and equity research divisions on a global basis. This followed a move in May 2005, when Goldman Sachs announced plans to merge its corporate bond and credit derivative sales, trading and research businesses with its equity business. Since 2002, Deutsche Bank, Dresdner Kleinwort Wasserstein, Lehman Brothers and Citigroup have combined their debt and equity research into single divisions.

Due to regulatory developments over the past few years (like Reg FD), many institutional investors are of the opinion that the research reports provided by sell-side institutions are of limited value. In addition, the profitability of sell-side firms is under pressure due to declining commission revenues and concerns over potential commission transparency. The integration of the credit and equity divisions will significantly enhance the value of research, as consolidated research departments will be able to provide an analysis of a company's entire capital structure. This would also help investment banks reduce the overall cost of their research operations due to synergies arising out of the integration.

Innovative research methods have yet to be implemented

The uncertainty over commission transparency has affected sell-side research. There is increasing pressure on the sell-side to unbundle its research and trade execution services as is evidenced by the recent move by Fidelity Investments and Lehman Brothers. Further, due to intense competition, the firms are trying to find unique value-added services to their clients in order to create differentiation. Unfortunately, few sell-side firms have been able to break away from their view that traditional fundamental research of companies is the most

appropriate research to offer their clients. As a result, traditional sell-side research has become less relevant than it was 10 years ago.

In fact, in a recent survey, it was found that the majority of institutional investors want direct access to company management instead of written research reports and stock picks. While in 2003 institutional investors paid approximately \$1.12 billion in commissions to brokers to arrange meetings with company management, this amount increased 25% to \$1.4²³ in 2004. During this same period, institutional investors reduced the amount they paid for “in-depth” company research or industry studies by \$800 million.

Average experience level of analysts on the sell-side is on a decline

The average experience level of sell-side analysts has declined in recent years due to the flight of experienced analysts to less conflicted or more lucrative research positions at money management firms and hedge funds. In addition, the sell-side has laid off or replaced a number of experienced analysts in an effort to reduce their research expenditures. In fact, many firms have replaced expensive analysts with either fresh recruits who have low to no experience, or by outsourcing a large portion of analysts’ work to low-cost centers like India. Since the quality of research is often linked with the insight an analyst has about a sector, or the relationships they might have with specific company management, we believe the quality of sell-side research has suffered due to a decline in the average experience level of sell-side analysts.

Sell-side objectivity: Recent developments

During the past year, many investment banks and brokerage firms have continued to try and address the market’s concerns over research objectivity with varying degrees of success.

Industry moves to eliminate conflicts

In one of the most interesting developments in the past year, a few sell-side firms have decided to do away with specific stock recommendations. In 2004, HSBC Holdings decided to phase out ‘BUY’, ‘SELL’ and ‘HOLD’ ratings for the stocks under coverage in order to bring more objectivity to its research. After HSBC, SG Cowen Securities and America’s Growth Capital also decided to stop providing ‘Buy’, ‘Sell’ and ‘Hold’ recommendations for stocks under coverage. It was hoped that dropping stock recommendations would have positive effects such as reduced conflicts of interest, thereby resulting in greater objectivity. These firms believed that doing away with the rating would ease pressure on their analysts to issue favorable recommendations. Also by avoiding recommendations, analysts would shift their research focus from a short term perspective to long-term, in-depth analysis – a move they felt would make their research more relevant to buy-side fund-managers.

However, in April 2005, HSBC reversed its stance and decided to implement “Attractive”, “Fairly Valued” and “Unattractive” to rate its stocks. We believe that HSBC’s change in approach is due to pressure from their institutional clients who felt that research without a rating reveals less conviction – a factor that reduces the overall value of the research. Based on the mixed results seen by Wall Street firms, it is not clear whether other sell-side firms will choose to eliminate “BUY”, “SELL”, and “HOLD” recommendations from their research.

More equitable distribution of stock ratings

Another interesting trend observed during the past few years relates to the decreasing percentage of companies being rated “BUY” or “STRONG BUY” out of the total companies under coverage. In 2004, 43.7%²⁴ of public companies with research coverage were given

²³ Source: Greenwich Associates

²⁴ Source: Wall Street Journal

“BUY” or “STRONG BUY” recommendations, down significantly from approximately 65% of public companies in 1996. This trend is a good indication for investors as it reflects less potential bias in research. The most likely reason for this reduction in the percentage of BUY recommendations is the decoupling of investment banking from the equity research divisions. Due to this single move, research analysts have less of a reason to give companies a BUY recommendation that might not otherwise be warranted.

Analysts drop coverage of companies due to management retaliation

In 2004 and 2005, there were a couple of cases where company managements refused to talk or provide information to the sell-side analyst covering their company. In one such instance, the analyst at Wells Fargo decided to drop coverage of Altera Corporation as the management refused to answer his queries. Unfortunately, this has not an isolated case. Earlier, in a similar move, Altera Corporation informed the J. P. Morgan Securities’ research analyst covering the firm that it would not interact with him any more. In another case, Mercury Interactive Corporation’s management curtailed its relationship with the Jefferies & Company’s analyst after the analyst published a report stating that the company’s sales orders looked weak. The fear of retaliation by company management is a major factor that has impacted the objectivity of sell-side research, as it could hinder analysts from issuing unfavorable ratings.

Sell-side costs: Recent developments

In today’s market environment, sell-side research is being challenged on multiple fronts. While on the one side, equity commission revenues are declining. On the other side, the costs of operations remain high due to increased compliance and legal costs. The decoupling of investment banking from research, concerns about potential commission transparency, and the fears that unbundling may be demanded by regulators or asset managers, have all changed the business dynamics of investment bank and brokerage firm research. We shall first discuss the issues on the cost front and then discuss as to how sell-side firms are addressing these issues.

Decline in commission revenue affects margins

Equity commissions continued their downward trend in 2004. As recently as 1997, sell-side firms charged average equity commissions of \$0.06 per share. However, by 2004, the average commissions charged on equity trades declined to less than \$0.04 per share – a decline of 33% in the past 7 years. The decline in the commissions is primarily attributable to the increased use of ECNs and Alternative Trading Systems and the decreased value attributed to traditional sell-side research in recent years.

The cost of trade execution using ECNs is approximately 0.75 cents per share (or lower), while under the traditional sell-side trading mechanism, it is almost double at approximately 1.50 cents per share. Investment managers are therefore routing their trades through ECNs instead of conventional brokers.

In fact, in April, 2005 the SEC voted to approve a new regulation, Regulation NMS that could exacerbate this trend. A major portion of Reg NMS – the “Trade Through” rule – has some market participants concerned that institutional investors may be forced to use ECNs even more aggressively in an effort to obtain the “best price” as outlined in the regulations. This would lead to lower average commissions and could divert commission revenue away from traditional sell-side brokerage firms and to electronic trading platforms.