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by Jim Lucas

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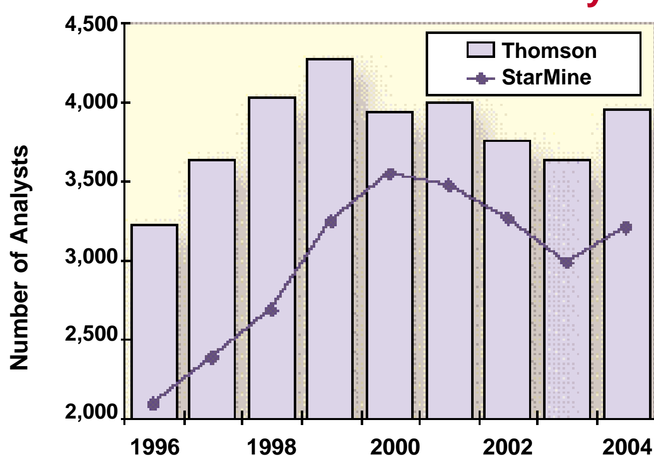
# A Surplus Amid a Scarcity of Analyst Coverage

By Jim Lucas

Only a few years ago, there were signs that new regulations and post-2000 market weakness would lead to a shortage of analyst coverage. For most IROs, however, things haven't worked out that way.

Large-cap companies, such as Northrop Grumman Corp., are awash with analysts. Gaston Kent, vice president of investor relations for the defense giant, said he's doubled the size of his roster to 22 analysts in the last five years. Partly, he's benefiting from a larger market cap as his industry consolidated. But Kent said he's also feeling the tug of deeper currents.

In the past year, Thomson First Call has tracked a 22 percent increase in the number of analyst recommendations in its database. In 2004, it counted 29,951 recommendations, up from 24,418 in 2003. Thomson also has tracked growth in the number and variety of new research operations that are independent of the investment banking firms — and it now counts about 4,280 analysts from all firms, compared with about 4,350 at the peak in 1999.




Sources: Thomson First Call, StarMine

"The primary change I've seen in research in recent years," said Kent, who has served as Grumman's IRO since 1991, "has been a new drive by analysts to sponsor trips and meetings with management. Our challenge is to be fair to each analyst while also being judicious with management's time." As IROs face the challenges of many analysts' requests, they find help in the new guidelines issued this year by NIRI and the CFA Institute, which give IROs new tools to allocate limited management time and resources among competing analysts.

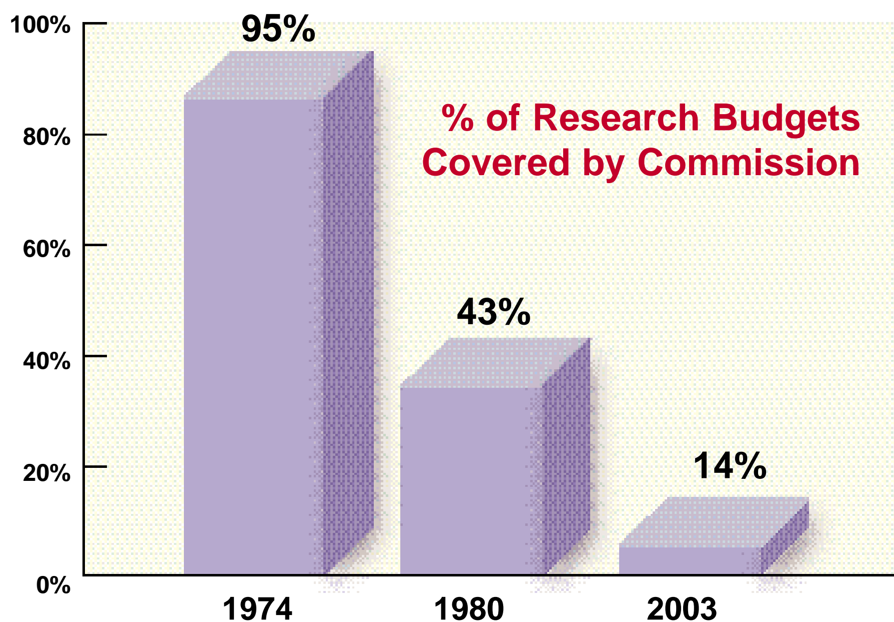
## High and Dry

The rising tide of coverage, however, has not lifted all the boats. Plenty of IROs remain stranded with little or no coverage.

The "orphans" include widely traded stocks on the S&P Mid-Cap 400 Index (median market cap: $2.2 billion in February 2005); 21 have two or fewer analysts — and about as many have 20 or more. (The median for the 400 stocks is nine analysts, essentially unchanged since 2003.) In the S&P Small-Cap 600 Index (median market cap: $750 million), 14 stocks have no coverage, while 18 have 15 or more analysts. (The median is five, up from four in 2003.)

## May Day

Today's environment — with its scarcities amid surpluses of analysts — is the product of forces that were set in motion after May Day 1975 marked the start of deregulation for brokerage commissions. Before then, fees were set at 30 to 80 cents per share traded, Wall Street paid its bills with trading commissions — and brokers, unable to compete on price, sought competitive advantages in a flood of research.




Source: Investment Dealers Digest, March 2004

As the tide of deregulation rose in the late 1980s, "discount brokers," online and automated trading, electronic exchanges and the rule that replaced fractions with decimal-based quotes further eroded commissions.

At first, Wall Street offset the lower commissions with a new revenue stream: Whereas investors' trading fees once funded most research, by the 1990s, investment-banking fees paid by corporate issuers funded more than half of big firms' research budgets.

Even that new source of funding dried up: new post-bubble rules prevented analysts from tapping investment-banking income. According to one study, research spending at eight big firms fell to $1.7 billion last year from $2.7 billion in 2000.

It made sense after the bursting of the stock market bubble in 2000 for IROs to worry that coverage would evaporate, especially when big brokers announced plans to focus on fewer stocks. But, as it turned out, the predicted shortage failed to materialize. Instead, Wall Street paid analysts less while reaching for new business models and revenue sources for its analysts.

With $2 million paydays fading into memory, the trade press quotes recruiters who say senior analysts command $150,000 to $700,000 a year. The CFA Institute put the median at $155,000 in 2003, down from $230,000 in 2001. Other surveys show the average analyst is covering more companies now. IROs, meanwhile, don't need a survey to know that conference calls and webcasts are drinking up more analysts' time than ever.

"A few years ago, we lost coverage from some bulge bracket firms when senior semiconductor analysts went elsewhere — with some of the best going to hedge funds," said Maria Quillard, senior director, investor relations at Xilinx, Inc., a $10 billion company covered by about 25 analysts. "As more non-technology-oriented shops feel they need to have additional exposure to semiconductors, new coverage is coming out of the woodwork from smaller firms that are not well-known in our sector. Now, most of our analysts are junior people."

## Course Correction

Wall Street also is plumbing the depths for new approaches. With one-cent-and-under fees available, analysts know their savvy clients won't pay five-cent commissions unless they get something more than just trading execution. In response, many are trying to add value by offering superior investment insights or taking companies on the road to introduce management to their institutional clients — or both.

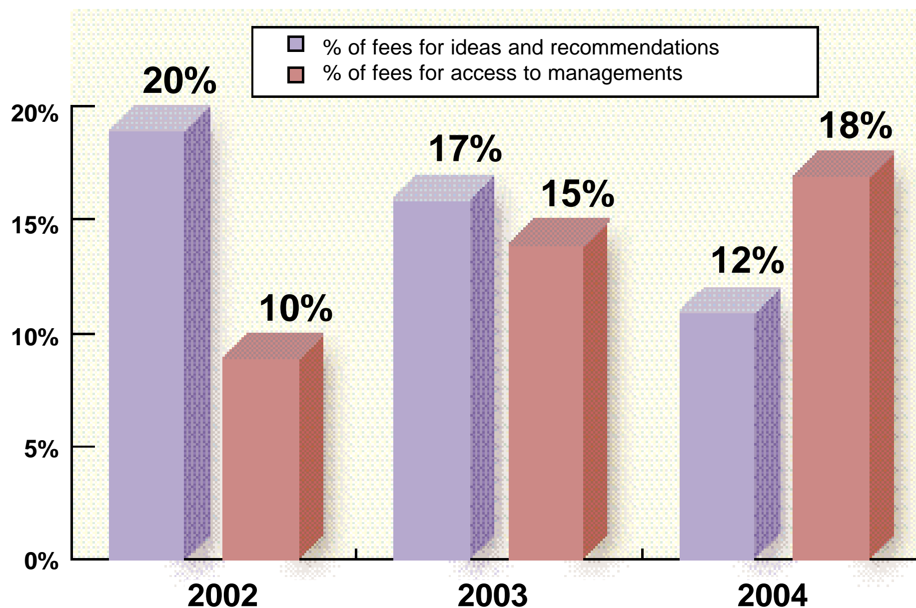
First, there are signs that, as a group, analysts seem to be improving their investment advice. According to StarMine, a subscription-based company that rates equity analysts, the recommendations of 3,200 analysts have pointed toward "average excess returns" (market-beating returns) of 1.3 percent in 2004 and 2.2 percent in 2003.

"Analysts continued to add value in 2004. When you consider that thousands of analysts went into this aggregate statistic, a 1.3 percent average excess return is quite impressive," said David Lichtblau, StarMine's vice president of marketing. This matters because, even in the era of tight research budgets, it's a truism on Wall Street that there are no budget caps on ideas that make money.

Second, analysts are seeking ways to add value by becoming a bridge between management and institutional investors (think "sponsored meetings and trips," which Kent said he is seeing at Northrop Grumman).

Greenwich Associates estimated that Wall Street attributes 18 percent of its $4.5 billion in 2003 research commissions to getting direct access to management — up from 16 percent in 2002. Many of the major sell-side firms have built staffs dedicated to, as some call it, "concierge services."

In this new world, analysts can even earn "soft dollars" without covering a stock, as became clear to Cynthia Guenther, vice president of investor relations at Avery Dennison. As she planned investor meetings in Europe for her Fortune 500 company, several analysts pitched their firms' services. "The most compelling proposal came from an analyst who didn't cover us," she said. "In addition to arranging a very effective series of meetings, he also obtained feedback from the investors we met with and summarized that feedback in a written report — at no cost to us."




**How money managers answered Greenwich Associates' survey questions on allocating research dollars for analysts' services.**

Source: Greenwich Associates, 2004

## The New Breeds

The wave of change also helped spawn new breeds of firms on Wall Street. Thomson Financial's First Call found that the number of independent research firms — those not associated with an investment bank — increased to 219 in 2004 from 76 in 2003. Or, as *The Wall Street Journal* reported in its annual review of research, "while Wall Street's biggest securities firms overhauled their research departments, boutique firms produced some of the year's best stock picks. ... The small shops pumped out savvy analysis, bolstered their ranks and anticipated big stock moves before their rivals."

Partly, Wall Street is responding to the needs of a new customer, the hedge fund. In the same review, the WSJ estimated that hedge funds control less than 7 percent of U.S. invested assets but pay 25 percent of all trading commissions. Hedge funds are making their presence felt in other ways: They cast more than one-fifth of the votes in *Institutional Investor* magazine's 33rd annual All-America ranking of analysts, and the trade magazine noted that "many analysts who have chosen to stick with the sell side find nonetheless that hedge funds are prompting changes in their jobs. These increasingly important and lucrative clients demand, for instance, recommendations on shorting stocks."

None of that, unfortunately, offers much comfort to the "research orphans" — companies that garner little or no coverage. Reuters Research has counted growing schools of orphans — most with market caps under $1 billion. A Bloomberg search of 4,000 U.S. stocks with market caps of more than $75 million revealed nearly one-quarter with 10 or more analysts and about the same proportion with one or none — with most orphans being valued at less than $125 million.

Pamela Murphy, vice president of IR and corporate communications at Incyte, said she knows how that feels. Her biotech stock had fallen out of the S&P Mid-Cap 400 Index and was losing an analyst a week until it began its recovery.

"Analysts are trying to make money off trading. If there's nothing interesting that will encourage transactions, then the stock won't be as interesting to analysts," Murphy said. Beyond pitching, the institutions that are right for the stock, she said, "small caps need to think about generating buzz and news flow that show the analysts and the buy side that you can deliver what you promised." In other words: Orphans can and should try to dig their own sales channels.

As we watch for the next waves of change, it's useful to ask: Do analysts — especially large numbers of analysts — matter to companies? There's only weak evidence that more analysts bring higher P/E's or more institutions. In fact, the sea of stock data reveals that companies with more analysts tend to be more volatile — though it's unclear if this indicates a cause or an effect.

What is clear is that volatility adds a risk that, in theory, ought to erode value — and plays to hedge funds that trade often and go long and short. Finally, it's worth remembering that the buy side hasn't always viewed the quality and relevance of sell-side coverage in flattering terms, and some IROs create value through approaches to directly target and reach investors.

That said, keep in mind Murphy's comment: "There's evidence, certainly in biotech, that an analyst rating change is a huge driver, second only to clinical and regulatory news."

We haven't felt the effects yet of, for example, changes in "soft money," brokers' in-kind exchanges with regular customers. Several money managers, including Fidelity Investments, are urging brokers to itemize the costs for services such as research that are included in the full-service commissions. That alone could touch off new waves of change. IRU

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