

Updating the Definitions of Equity Research

As a result of the recent market collapse, bank mergers, global depreciation, AIG's melt-down and a host of similar negative news in the financial markets; some investment banks have decided to exit the research business altogether based purely on economic rationale. Since the ties were broken between investment banking and research; there are now few incentives for Wall Street firms to cover less liquid and emerging healthcare small - cap stocks.

Equity research is a discipline within the financial services industry. Equity research professionals are known as analysts whose job is to discover, develop and communicate insights (coverage) of a particular company. This enables the investment community to benefit from a third party's objective perspective. Typically, research attempts to define at a particular moment, the value, risk, and volatility of a particular security or market segment to assist investors in deciding to buy, hold, sell or monitor.

The investment community consists of a broad spectrum of institutional professionals, asset managers, and retail brokers down to the individual investors. Research analysts conduct due diligence, define technology platforms, measure comparables (similar or associated companies), define benchmarks and milestones for a target price as well as conduct quarterly reviews of financial disclosures; they also track relevant industry news using trading, industry databases, management interviews and channel-check the medical community to define their investment thesis.

Equity research falls into two broad categories; that provided by investment banks (I-Banks) and independent equity research firms (usually boutiques). I-Banks offer research multiple financial services including broking and corporate finance. Independent firms came into existence as a result of the Spitzer era of decoupling research and investment banking with a global settlement.

The Receding Tide

Money managers are experiencing multiple rounds of job losses as redemptions show no signs of slowing. Capital Group is in the third round of cuts and freezing pay with 6% of their staff already cut. Fidelity has cut 7% of their staff with Franklin Templeton, MFS, BlackRock, Alliance-Bernstein, State Street, LeggMason, Janus, Pimco, Boston Company Asset Management, Putnam and many, many more reducing staff. Hedge funds and private equity firms which had been the new homes of departing I-Bankers and analysts have also been hammered by depreciation, redemptions, closures and mass investor exits leaving many escapes from the investment and research side left by the side of the road. Close to 1500 hedge funds (15 %+) closed in the past year.

Wall Street research departments have followed by dramatically downsizing resulting in an estimated 50% reduction in analysts lost over the past year. Consequently, many public companies (estimated 50%) and equally important, the investment community is now deprived of research attention and coverage. Many companies that have coverage (75%) are under only covered by those investment banks that act as their underwriters.

Wall Street research isn't driven by the best investment ideas and opportunities; lately, it's driven by getting get paid by trading volumes. Analyst head count is driven by trading volume; particularly at firms that don't have investment-banking businesses. These firms earn fees based on whether the stocks on which they produce research generate trades. Market capitalizations have suffered in this market melt-down in comparison with companies that do have such coverage. As the market rebounds, uncovered companies will subject to higher financing costs when compared with their analyst-covered peers.

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The Receding Tide (continued)

Bear Sterns' demise doomed the financial market putting many analysts on the street pre and post being acquired by JP Morgan and Lehman Brothers Holdings Inc's bankruptcy upended the Wall Street investment banking model (although some analysts were picked-up by Barclays). Merrill has suffered dramatic turnover since being acquired by B of A whether by forced or voluntary terminations. Smith-Barney (Citicorp) has been spun off with a pending merger with the brokerage unit of Morgan Stanley. Cowen & Co reduced analyst headcount. Even, Goldman Sacks laid-off a number of analysts. UBS is reducing staff again amounting to 20% amid mounting losses and customer defections. Nomura has cut banking and analyst staff, including many who were part of the contingent acquired from Lehman (mainly in Asia). Almost all firms have retrenched, reduced analysts, sold off channel-check subsidiaries as well as institutional traders.

The list of I-Banks reductions could go on; but until the capital markets open up, not much will change. Rodman & Renshaw has recently laid-off analysts and 20% of staff upon the demise of the PIPES market for which their research was totally based. Trading volumes are dramatically down and many small and mid-size brokerage firms will continue to cut overhead and reducing staffs.

Fulcrum Global Partners founded with much fanfare in 2001 was an alternative to traditional Wall Street research, But, Fulcrum shut its doors and resigned from the National Association of Securities Dealers. Despite reams of press coverage and an initially warm reaction from "buy"-siders, Fulcrum found that clients simply weren't willing to pay up for premium research. And without the massive capital base and diversity of revenue streams of their investment banks clients, Fulcrum could not compete.

Fidelity recently laid-off 46 people, including 22 research analysts, at its core FMR Co. mutual funds unit. For this same reason quant screens are often used to identify small companies that may be attractive on paper, but may "ignore" compelling qualitative factors that might "dictate" a future investment. B of A also suffered a major reduction in the quant (many Merrill) area as have most major financial related institutions.

Meredith Whitney, whose bearish call on Citigroup earned her a large investor following, left Oppenheimer & Co to launch her own research boutique and the musical chairs of research analysts continue each week, some to setting up independent firms. However, JM Dutton, a major provider of independent research closed its doors recently, as the current market environment prompted smaller public companies to obtain research coverage and is no longer in business. Consequently, Dutton's 18 analysts - most of whom have decades of sell-side or buy-side research experience found themselves out of work.

In the past, a growing number of mutual funds and brokerage firms adopted unbundling to pay for execution and research services separately. Paying for research with "hard dollars" had been embraced by some financial service institutions. These moves lead to a reduction in the commissions received by investment banks for their execution services and equity research. Money managers do not want to move to a "hard dollar" payment model, as this would reduce their profit margins, whereas paying for research with commissions (soft-dollars) means the investor is paying for it directly. The SEC has reviewed and limited these platforms as questionable usage abounded and then some. Thomas Weisel had charged clients separately for stock research, trading and unbundled its research and trading products charging separate fees for trading execution and research still suffers from this challenging environment. Pacific Growth Equity had also overhauled the way it distributes its research late last year, by creating (analyst+ trader) teams dedicated to paying clients, which are exclusively institutional investors

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The Tide Always Comes In

Research coverage of emerging companies' stock is still the starting point of an investment decision. It's extremely time consuming for the "buy-side" to do primary research on large numbers of stocks that may well end up being 'passed' on in this period of downsizing. Shareholders' and prospective investors have been limited in their ability to obtain an analysts (informed outsider's) perspective on identifying strengths, weaknesses and comparables.

Investors are asking more questions about the short, near and long term viability of emerging small cap healthcare company stocks in particular, their sustainability. Fear seems to be eroding in this market with a lot of buzz about the near term future (at the Cowen conference) on healthcare equities. This lack of coverage lessens information available to investment bankers, fund managers and individual investors, making markets less efficient. Analyst reports trigger the buying and selling of shares while the lack of such coverage frustrates the formation of a robust trading market.

Investors and shareholders need independent verification and review analyst reporting as one major source of verification that companies are meeting milestones and reaching established goals. Independent equity research firms in the future have and will fill the coverage gap created by the multiple events incorporated by the market turbulence by providing research on orphaned stocks. Independent firms are becoming the main source of information on the majority of stocks as investors are reluctant to pay for research.

Small cap emerging healthcare companies' valuations and access to investors have been squeezed by the current market turbulence. Even if the economy continues to spiral downward; the current economic environment has favored holding depreciated biotech, medical-equipment and life-sciences stocks. When capital market access becomes available, their difficult times should be over and many well-focused companies will emerge onto the playing field stronger than they are today. But, many, if not most, emerging healthcare equities are not investible as hesitant performance, burn-rates, regulatory achievement and timing questions of capital market access shifted the mood away from platform optimism as seen in the past.

Analyst reporting has an eager audience as investors need to be reassured and enlisted. Perceptions of risk in platform/technology, regulatory hurdles, valuation and capitalization must be independently verified through transparent reporting of milestone attainment. While, press releases present a factual representation of an event; they do not articulate the effect upon present or future valuation or pricing catalysts. Many investors also don't value management (usually self-serving and overly optimistic) input but do regard third-party, analyst definitions of milestone fulfillment and benchmarked comparables as an important ingredient in developing a conviction for investing.

A consistent flow of coverage still attracts and retains a constituency of investment professionals. Independent research analysts will play a critical role in this process. But, who is going to pay for new idea research and re-establish coverage for orphaned healthcare equities independent equity research firms. Traditional I-Banks provided research in order to finance clients in bull markets. I-Banks will re-enter this space as the fee generating financing market for PIPEs and IPOs open. There is no quick fix; but, timely research coverage still legitimizes and focuses share price sustainability. Since the market has affected the employment of equity analysts; asking brokers for a company review that is unavailable will not generate commissions. As their economic model is squeezed, funds and asset managers are unwilling to buy research; not understanding how or will increased perceptions of risk should be measured and monitored in relation to disease platforms, burn-rates and the costs of regulatory initiatives.

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It is now harder for a company to obtain research coverage through existing I-Bank's difficulties in bridging the gap between the high costs of its research operations, deteriorating commissions from equity trading and the lack of capital market access. Since the ties were broken between investment banking and research, there are now few incentives for Wall Street firms to cover less liquid smaller-cap stocks. The U.S. Securities and Exchange Commission in hearings for the SEC Advisory Committee on Smaller Public Companies has encouraged independent equity research as a legitimate market tool for smaller public companies as part of its congressional mandate.

Scimitar Equity

Scimitar Equity, LLC (Scimitar) is an independent equity research and advisory firm without banking and trading conflicts. Our vision is to provide investors with time sensitive intelligence and our mission is to define the short, near and long term catalysts to facilitate share price discovery and recovery by defining actionable investment analysis and benchmarked valuation models. Our research and analysis has played a key role by providing analysis and insight to I-Banks, retail and institutional investors.

The biggest issue for paid for research model is being viewed as being highly optimistic and conflicted since leverage could be exerted by the company paid model in influencing valuations. Scimitar has intentionally stepped back from price targets by defining a valuation number with a - published - quantitative model supported by a - specific - qualitative explanation. No part of our valuation recommendations has ever or will be influenced. Our company-paid model maximizes transparency, strict adherence to standards of ethical business practices. Scimitar's model of paid for research continues to gain acceptance.

Scimitar's research is also distributed free-of-charge, unlike I-Banks that typically limit research distribution to commission paying institutional clients. Thus, our credibility as an independent equity research firm has gained a significant following as investors continue to seek increased transparency and economic efficiencies in reporting from trustworthy sources.

Scimitar understands that timely intelligence is a valuable resource that galvanizes a back channel or unofficial communication network. We have become a major source for sensitive issues such as supplemental diligence from asset managers and brokers. Investment decisions are more frequently made through these alternative avenues of communication. We also provide fund and broker access to align, retain and attract new investors to generate valuation appreciation.

Now in our seventh year, we have developed relationships with a network of asset managers, institutional advisors, high-net worth individuals and other investment professionals. Scimitar's capabilities are differentiated through years of sell-side and buy-side, corporate and venture/public investment fund communities resulting in an extensive investor network.