THE EQUITIES WORLD IN EUROPE IS SHRINKING.

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13/02/2017

The banking world has seen enormous change since 2008. Many changes were necessary reactions to the causes of the financial crisis, and these have been commented on by people smarter and better informed than I (Thomson Reuters, FT, WSJ). What I started to be concerned about in my previous career as an equity capital markets banker, was how some changes to bank and investor operating models in Europe are fundamentally altering the nature of the equity businesses that service listed companies.

This sounds a rather dry subject: until one starts understanding the links between issuers and investors are becoming tenuous, and the routes to access new investors are changing. Ultimately, one could imagine the cost of equity increasing, as these changes put pressure on equity research, equity issuance, and investor relations planning.

Why are these changes happening?

1. **The addressable universe of actively managed funds to consume equity research, and service the needs of European new equity issuers and listed companies, is shrinking.**

   European equities attracted more net flows in 2015 into passive funds than into active, and market participants tell me it was the same in 2016. In the US, passive funds are predicted to reach 50% of stock and bond markets by 2021. Country-specific equity portfolio assets are shrinking in preference for regional or global funds which naturally have higher minimum market capitalisation tests. The number of hedge funds, who by their nature tend to be highly active, has been falling net of closures vs new openings. All this means there are fewer actively managed funds to consume equity research, and service the needs of new equity issuers and listed companies. At least, for all but the largest listed companies.

2. **The number of equity research analysts is reducing. Globally, there are 10% fewer since 2012.**

   Banks are under regulatory and shareholder pressure to reduce costs and improve returns on equity. This has well understood implications for balance sheet availability, ie the willingness of banks to lend/fund. What is less obvious from outside the industry, is this reduction in headcount also affects parts of the banks that rely less, or not at all, on balance sheet related activity.
   In equity research, analysts have been hit with a triple whammy. Cost control is the first part of it. Second, research analysts are barred by regulators from being compensated by Investment Banking. Rightly, as this is a direct conflict of interest with analysts' obligation to provide an independent view. And third, when combined with the changes above and below, Research's own client base is shrinking. No surprise that research analysts are increasingly voicing frustration at being asked to justify their product.

3. **Investor research budgets have shrunk in recent years and a further 25-30% reduction by 2020 is suggested.**

Due to MIFID II research unbundling, investors are questioning and quantifying what they want to pay for sellside research. Previously, sellside research formed part of the overall equity service by each bank, and fund managers paid for this service by directing

trading flows and commissions through each bank. Part of Europe's Market in Financial Instruments Directive II (MIFID II), requires fund managers to pay for research either from their own account or a client research payment account starting in January 2018.

This regulatory change severs the link between provision of sellside research and execution services.. What is certain is in future banks' research departments will be less able to provide regular content on a broad range of stocks, as quite simply it won't pay to do so.

What do these three systemic shifts imply for European companies who want to attract quality research coverage, and ultimately the attention of investors? It'll be important to understand what investors will be willing to pay for. And to which part of the equity value chain the relevant research analysts will transition.

A big issue with the broad research written by large investment banks is the extreme duplication of content. To be fair to investors, who really needs 200 pieces of content a month on Facebook? After all, the core value of research is to give investors a unique insight that will help the investor identify market under/overvaluation, and position their portfolio accordingly. Sifting through hundreds of reports to find that nugget of gold is time consuming and no surprise, even when found, how to decide whether that analyst's unusual insight is valid, or a wildcard guess?

The good news in all of this is that investors are likely to continue paying for market leading research. Remember the work product of these stars is being formally recognised by investors, and paid for, due to research unbundling.

But where will these star analysts want to work? Big banks wanting some flexibility for the remainder of their business, may wish to stick with broad sector coverage, Inevitably, not every bank will have a top 3 analyst in every sector and even then, an individual analyst cannot publish frequently on more than 15-20 stocks. And obviously, these star analysts who generate the bulk of research revenues, will have to subsidise the rest of the team. It's not difficult to see the leading analysts making different choices in order to be paid a greater share of the revenue earned from their personal franchise.

I've identified four broad trends which may determine the directions of travel for equity research; Specialisation, In-House, Datamining and Outsourcing.

Specialisation will see some banks focusing their equity research and (to some extent) corporate finance activity, on a few sectors where they have a genuine edge. Specialisation is also taking place with the continued growth of independent research houses, based around a strong skill base and lower costs than in a full service bank.

In-House will see fund managers concluding they are better served by setting up or enlarging in-house research. One implication of this is the top rated sellside research analysts may decide to jump from buyside to sellside, making them less accessible to listed companies.

Datamining is already widely used in the hedge fund industry where technology-based investment systems are among the top performing funds. And this can be a valid approach to apply when applied to equity research. Indeed, more than a decade ago, I IPOd a hedge fund strategy which used a proprietary system to analyse the information from equity research, feeding into algorithms that then ran equity portfolios. This system paid for research which subsequently generated real returns. So it won't be surprising to see the post-MIFID II systems that measure the impact and quality of research reports for fund managers, also feeding into prioritising and executing trade ideas from analysts with a good track record. For the bulk of less obviously valued research, big data investment systems can trawl through them for the hidden gems.

Outsourcing is a less painful option for banks that are faced with radically cutting or shutting down entirely their equity research. Particularly if they want to keep the option of a broader research base to help their corporate clients seeking access to the capital markets, without the costs, it is perhaps the only option.

What do these systemic shifts imply for European companies wanting to attract quality research coverage and the attention of investors?

The short answer is – the traditional research analysts will be more, and less, important. From 2017, control over the relationship between company and investor will revert to the company. Where there is a star analyst covering the company, that analyst can be tremendously useful (both for positive profile raising, and for negative warning signs). But the company will need to manage its own relationships. Not least in anticipation of that analyst moving on.

Yet so far no-one, neither the banks nor the investors, knows exactly what will happen nor when. The banks have yet to publish price lists for their research. Until those are public, the investors cannot decide whether to pay for sellside research, in-house it, or rely on an independent research house.

What is certain is that the number of investment banks offering across-the-waterfront coverage of European equities will reduce. One significant UK investor suggested to me last week that perhaps only four banks might do so from 2017. What's more, those few banks will want to monetise in full their research product. The negotiations may require each investor to choose between a full delivery, or being cut off. Indeed, the risk of reduced research access for investors (and therefore of bank relationships into investors) has been a material topic of my discussions around this in the past few days.

Impact on Equity Capital Markets

At the London Stock Exchange IPO Conference in October 2015, the CFO of a recent IPO issuer said "It was only after the deal that we realised we had been flirting with the bankers, however we married the research analyst". The research analyst of the syndicate banks is an important part of the dialogue between the company and the market. These connected research analysts write transaction related independent research. This is published by the analysts and discussed by them with the interested investors, before the prospectus is published and before the management itself goes on the roadshow. And these analysts will usually continue to publish research on the company after the IPO.

It's no surprise therefore, that choosing these analysts should be a significant part of the issuer's and shareholders' choice of banks to introduce them to the public market. The reality is that it's perhaps not been treated by issuers as importantly as it deserves. The analysts may after all be the best specialists here, often in the sector and certainly in accessing the target investor audience.

There are few datapoints so far to indicate how the ECM world might respond to the changes I discuss above; however, I think the following three areas will be important.

The client's choice of bank syndicate will rely more heavily on the analysts at the expense of the bankers.

I talked earlier about the increasing importance of the star research analysts on the sellside (i.e. inside the banks). Smart issuers will focus more closely on those analyst's rankings, at best alongside or perhaps even instead of who their primary banking relationships were with pre-IPO. Issuers may start asking the banks how much each analyst earns from the buyside for their work. Admittedly, this will depend on the research price lists being on a per-analyst basis. Although companies doing pre-IPO investor meetings are free to ask buyside investors which of the sellside analysts they rate highly and are willing to pay for!

What I think will become increasingly common is issuers meeting with the sellside research analysts both before and during the beauty parades, and at least once after the banks are hired. This already happens to some extent, albeit less frequently than it deserves, in part due to the compliance concerns of the banks. These meetings can be achieved within the bounds of the banks' compliance policies, however much the banks might wish to discourage them.

And given the important of the star research analysts, companies should be more prepared to fire syndicate banks if the research analyst moves.

Independent research houses to win research-only roles in IPOs to compensate for the reduced universe of sellside research.

The Financial Conduct Authority is reviewing the IPO market in the UK. As part of this review, it has examined the lack of information available to independent research houses in IPO situations. And as part of the proposed options, it is considering making the prospectus publication earlier, so it takes place at the same time as the connected research is published. By the way, this is the first time I'm aware of a major regulator formally acknowledging the role of connected research in an IPO. An important regulatory point which I will review in a future article.

Should the FCA conclude there is investor demand to receive independent research in IPOs, issuers will be encouraged to include the independent research houses in their processes. Which will have the major benefit that issuers will be able to capture those star research analysts who have moved to the independent research houses. As the universe of sellside research analysts almost certainly continues to shrink, this is a potentially important option for issuers.

Disintermediation of the banks – direct access by issuers to the buyside.

Banks equity desks will have fewer equity accounts to sell to, once the double whammy of cost reduction and MIFID II have worked their way through the system. An issuer will be faced with choosing banks to provide research and distribution, with an increasing concern that those banks no longer provide "across the waterfront" sales and research coverage. What might happen if the banks selected do not have an equity relationship with some – or all – of the key target investors? I think that's going to be tough to find out ahead of time, frankly. Banks will fight to avoid showing any areas of weakness.

Disintermediation addresses both the research and distribution problems. While it's early days yet, it's interesting to see platforms springing up to provide direct investor access for roadshows (e.g. ClosIR), and to provide electronic order taking from investors (e.g. Dealogic Connect, Issufy). Combined with independent research, it's not impossible to see IPOs and other capital markets transactions potentially having at least a portion of disintermediated access to the investor base. For what it's worth, this may be more frequently trialled in the debt markets, particularly for seasoned issuers, before it comes to the equity markets.

Of course, my legal friends will remind me there are material regulatory issues to involving broad-based IR aggregators or demand takers in a capital markets transaction. These aren't insurmountable, however an issuer wanting to take advantage of this new route to market should recognise there are important procedural issues to address, so as to avoid penalties for offering inappropriately.

Impact on Corporate Access

It's no surprise that if the relevant sellside research analyst community shrinks, and equity salesforces/corporate access teams continue to be cut, corporate access via the banks will become increasingly difficult for issuers. The fight for investor attention will become more acute. I see the trend of the investor relations role becoming strategic accelerating further. I've even seen one company where the head of IR intermediates on behalf of CEO and CFO not just to the buyside and sellside research, but also to the bankers.

What are the likely changes in corporate access that could result from the shrinking equity world?

Measurement of sellside analyst consensus to become more difficult. With reduced sellside research coverage, companies will have a smaller universe of contemporaneous published reports off of which to base their consensus guidance. And if consensus is not a reliable yardstick, it raises a big question on how companies might guide the market on expected earnings. This is a tricky one: companies are on the hook for their guidance. It's possible, but unlikely, regulators will loosen up on the requirement for auditors to report on company forecasts if these have been made public. In the meantime, companies will have a difficult choice to make on just how detailed they wish to be without giving up specific revenue and profit figures.

Increased number of group events to address lack of reach of the banks. It will be less effective to rely on a single bank for each roadshow, not least as their sales relationships will be shrinking for the reasons discussed before. So more group events and capital markets days will be an efficient use of time to address a maximum reachable audience. Particularly when combined with the following.

Direct IR platforms (e.g. ClosIR) to access the broadest possible community with notice of the company's IR calendar, and also to get prior notice of indications of interest. This will also encourage independent roadshow logistics providers (e.g. Snowdog Roadshows).

There are many factors at play here, and the next 18 months potentially sees the biggest change for a decade or more in the European primary and secondary equity capital markets. Issuers preparing for an IPO have previously measured a successful transaction through a well-covered book of demand and a good price. That will no longer be sufficient.

The changes going through the European equity markets today will mark a significant shift in achieving success at the IPO and after. What is undoubtedly true is the best outcomes will be from those companies which consciously realise they are competing for investor attention post IPO, invest ahead of time in the self-awareness, relationships and systems to maximise their appeal, and are fully prepared to act as a public company from day one.