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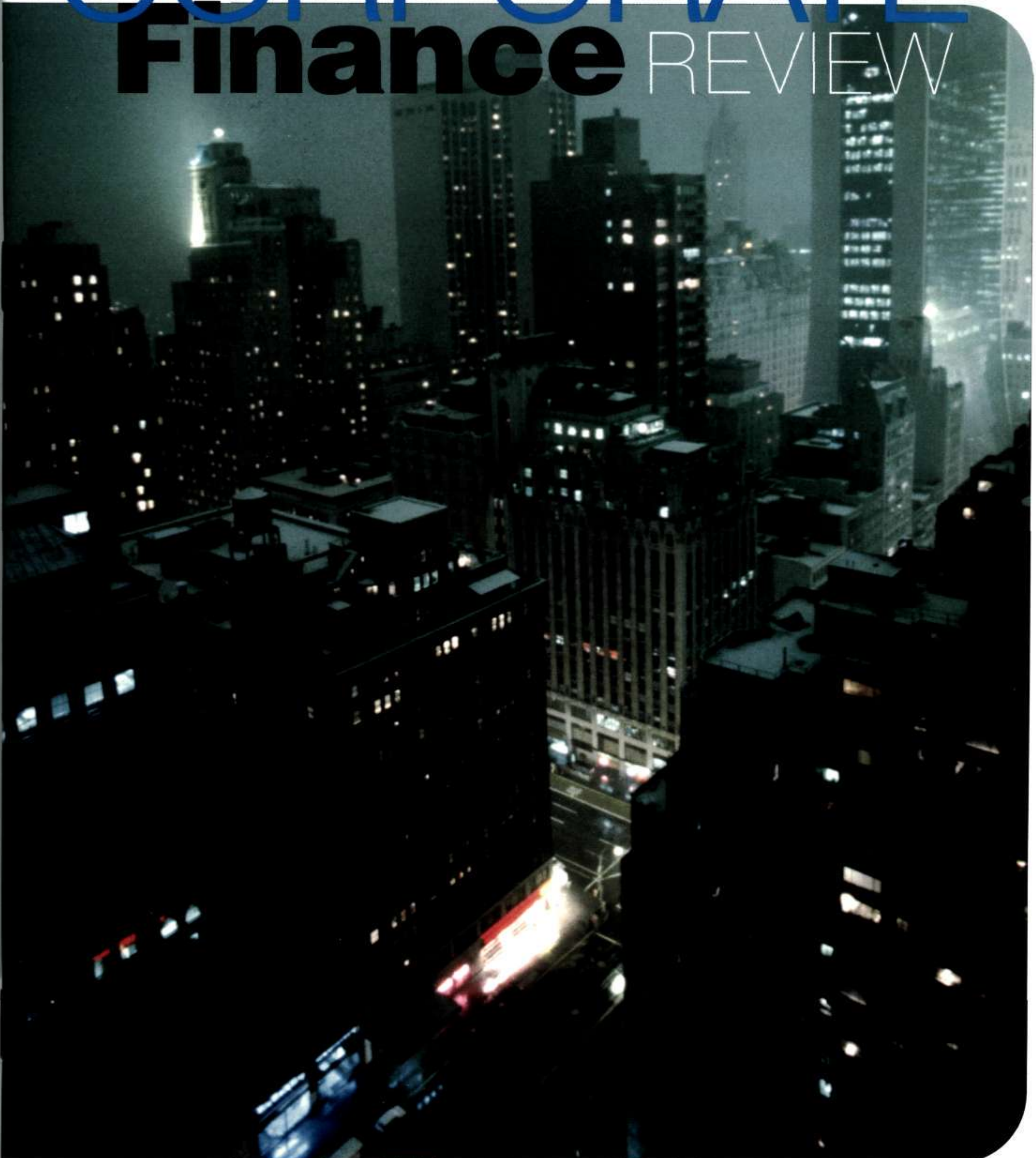

Selling a Company: How to Decide and Prepare

The Lessons of the Subprime Loaning Market

Cost-of-Equity Irrelevance Regarding Tax

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IN A BLINK: RESEARCH IS CONFIRMING KEY TRENDS IN FINANCE, CORPORATE REPORTING, AND CAPITAL MARKETS

You were certain you knew a particular thing, but the thought needed confirmation. However, there was no time for fact-finding or research. Acting on a hunch you made a necessarily quick decision. Was your hunch right? Most often the answer is yes, our hunch was correct and the right course was taken. The best-selling author Malcolm Gladwell captured the power of human hunches and intuition in his book, *Blink: The Power of Thinking Without Thinking.* The "aha!" moments that we all experience, he wrote, come from "thin slices ... a little bit of knowledge [that] goes a long way."[1]

Author Gladwell tells the story of a famous marble statue displayed by the J. Paul Getty Museum in Los Angeles. All the experts agreed it was a great find at only $10 million from the dealer. The *New York Times* featured a page-one story about the piece. Art writers absolutely glowed over the sixth-century BC sculpture of a male youth. One expert—literally in a blink of an eye—looked at the piece and asked the curator, "Have you paid for this? If you have, try to get your money back." The piece was a fake! The expert was Thomas Hoving, former director of New York's Metropolitan Museum of Art. He had examined thousands of art works over decades of his career. In just two seconds he was able to understand more about the *essence* of the statue than the team at Getty did after fourteen months.

Professionals in finance, accounting, investor relations, and related activities can often in a blink understand and act on what their experience tells them is the right course. Pivotal moments in history occur, changes can be enacted overnight, new paradigms emerge (think of pre- and post-Sarbanes-Oxley for a twenty-first century paradigm shift), and later, the experts roll out in great detail facts, findings, and opinions, which usually end up confirming that the professionals' hunch was correct.

In recent months, a series of reports have been issued by academics, consultants, accounting and financial professionals in teams, and others, and in reading through these, it seems that many of us knew or correctly sensed that the reported findings were occurring. We will look at two such reports related to financial research and analysis. Upon issuance these reports were shaping media coverage and public opinion among finance and corporate executives, regulators, and others.

The Global Settlement and its impact

Remember the headlines when then New York State Attorney General Eliot Spitzer pursued the Big 10 investment banks/brokerage houses that were accused of slanting financial research and analysis to fit the marketing needs of investment bankers and their clients? After much *Sturm und Drang,* all parties settled and created a cumbersome, difficult-to-understand structure for creating "independent" research to be made available alongside the houses' own research and

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analysis. There are far too many details concerning the Wall Street-Spitzer "Global Settlement" to go into here (we have commented on the settlement in past issues of this publication[2]), but at the time there were opinions all over the map on what this would mean in the months ahead. The investment bankers made their displeasure known quickly by stopping analyst coverage of hundreds of companies, and dozens of analysts began shipping their resumes around town.

What was your hunch at the time? Here is what a team of experts convened by the CFA Institute write in the September/October issue of *CFA Magazine* after surveying the current "independent research environment":

> The inevitable backlash produced regulations that separated investment banking from research—and a promise by the major brokerage houses to buy outside independent research and offer it to their retail clients (a deal known as the "Global Settlement"). This pot of brokerage house gold caused a surge in the number of independent research shops in the United States and Europe. But instead of ushering in a new age of stability and rationality, the Global Settlement was only the beginning of a new, even more frenetic burst of evolution. Today, instead of just one or two industry-changing trends, there are at least six, all intersecting simultaneously.[3]

Following are the six"industry-changing" trends:

- Execution costs are plunging, resulting in fewer soft dollars for research funding.
- Regulation Fair Disclosure, enacted before the passage of Sarbanes-Oxley in July 2002, brought transparency to analyst-corporate issuer relationships and gave more visibility to the "sameness" of reports coming from the traditional independent research and brokerage houses.
- Mutual fund revenues are falling (thanks to low-cost exchange-traded funds), meaning less money for research.
- Soft dollars are threatened as Securities and Exchange Commission Chair Christopher Cox asked Congress to ban soft dollars and require asset managers to pay for research with "hard" dollars.
- The sell-side of research is consolidating as "client commission arrangements" eliminate the need for mutual fund managers to trade through a broker to get their research. Today, brokers compete to provide low-cost (and best-execution) business and buy each other's research offerings.
- Private equity is growing, and there is no sell-side or perhaps even independent research needed for the "closed circuit" of private equity investing. And best-in-class researchers and analysts are probably going to work for private equity firms if they are really good at what they were doing on the sell-side.

How many of the six trends were evident to you "in a blink" as you monitored the changes in the research/financial analysis environment? And what is ahead? The referenced *CFA Magazine* article looked at independent research models that could work in the future and profiled a few small research shops with unique service offerings.

THE TYPICAL REASON ANALYSTS DROP COVERAGE IS THAT THE FIRM APPEARS TO BE UNLIKELY TO PROVIDE FUTURE INVESTMENT BANKING OR TRADING REVENUES FOR THE ANALYST'S HOUSE.

More on the loss of analyst coverage

So while the six major intersecting trends were occurring over the past five years, what was it like in the corporate suite as analyst research "disappeared"? A recently published report—"Is There Life After Loss of Analyst Coverage?" — looked at 2,753 issuers that lost analyst coverage and found mostly bad news for the companies involved.[4] The typical reason analysts drop coverage is that the firm appears to be unlikely to provide future investment banking or trading revenues for the analyst's house.

So as analyst coverage goes away, the following begin to occur for the orphaned companies:

- They are most likely to "deteriorate" within the first two years.
- They are more likely to be de-listed from their exchanges.
- They are more at risk of bankruptcy.

- They may be approaching liquidation.
- They, in general, fare worse than their "control" (covered) counterparts in the study.

Institutional investors may be more inclined to divest/not invest if coverage is dropped. The Global Settlement was a factor in brokerage houses and investment banks "not finding it economically beneficial" to provide analyst coverage.

The three researchers examined why analysts permanently halted coverage of companies and what the consequences were of the loss of analyst coverage. The authors found that when analyst coverage was dropped, the company often sought other coverage and even bought independent coverage. Or they switched underwriters between their initial public offering (which may have been underpriced to offset research costs) and secondary offerings (when these were "more seasoned" for the market).

According to the report, one of the primary reasons for analysts to drop coverage was that they saw little or no future investment banking business from the firm.

However, the report posited that a decline in operating performance was a weak reason to stop coverage. And return on assets is significantly related to the decision to drop coverage only at the 10% level. Variables such as sales and asset liquidity are not significantly related.

The "hanging questions" that you may be thinking right now—and here your hunch or intuition comes into play—possibly include the following:

- What is going to happen to sell-side research over the next five years?
- If half of all issuers do not have sell-side coverage now, what happens as even more firms become coverage orphans?
- Will paying for independent research (by an issuer) become more acceptable to investors, and especially institutions, in the future?
- Will buy-side researchers begin to talk publicly about their research as they did when employed as sell-side researchers?
- Will research become an important "carrot" dangled by the buy-side for certain kinds of business (e.g., perhaps managing the issuer's 401-k employee plan)?

Future researchers will spell some of this out in their detailed reports and offer their findings and opinions. By then, months or even years will have passed. It will be the finance professionals' hunches and intuition (and experience) that guide their enterprise through the dynamic changes taking place in financial analysis and research.

One bit of information that you might crank into your subconscious: Research and financial analysis is not going away: The CFA Institute reports all-time highs in membership and in studying for the designation the institute grants. •

NOTES

1. M. Gladwell, *Blink: The Power of Thinking Without Thinking,* (Back Bay Books, 2007): 18,
2. See particularly, "Independent Financial Research: Changing the Way Investors View Research?" in *Corporate Finance Review's* May/June, 2005 issue.
3. J. Rubion, "In the Rough," *CFA Magazine* (Vol. 18, No. 5, September/October 2007): 31.
4. P.R. Rau, S. Mola, and A. Khorana, "Is There Life After Loss of Analyst Coverage?" (August 2007, working paper).