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## **FRESH IDEAS**

### **The New Economy**

#### *Issuer-Paid Research Comes of Age*

**BY ROBERT SCOTT MARTIN**

Fresh ideas are the lifeline of the buy side, but with two out of every three U.S. listed companies going without coverage from a single Wall Street analyst, professional investors on the hunt for orphaned and overlooked stocks are tuning into research shops that take a new approach to the business end of stock analysis.



"Over the last few years, a number of things have developed," says Gary Strong, chief operating officer of one of these shops, Spokane, Wash.-based RedChip Resources. "Most notably, 64 percent of all publicly traded companies do not have sell-side analyst coverage. That's just on the NYSE, the NASDAQ and the AMEX. Take all companies and get into over-the-counter stocks, and that jumps to 80 percent."

RedChip has no brokerage operation racking up commission dollars to subsidize its research activities. Nor does it have an investment banking affiliation that could carry its analysts or fuel conflicts of interest. And unlike subscriber-driven shops, every report that the firm's analytical team puts out is available to investors for free.

### **RedChip Resources: Top Picks**

**Syntroleum (SYNM).** "A unique story. They have developed onshore and offshore capabilities to go in and tap into natural gas not otherwise accessible, converting it on the spot into jet fuel and diesel. I think there's been some interest from the military."

**Magnetek (MAG).** "Magnetek's operating margin has improved considerably over the past year, although it still lags the median of the industry peers. However, with revenue growth over the past year far outstripping that of its peers (Magnetek posted 27.6 percent year-

over-year revenue growth) and management's continued efforts to improve operating leverage, Magnetek's EPS growth rate assumptions and valuations should now be comparable to its industry peers and the shares should be valued accordingly."

**Caneum (CANM.OB).** "A unique value proposition. Caneum differentiates itself in the growing business process outsourcing market by not being presumptuous about what, how, and where outsourcing should occur, allowing the company to engage resources when and where needed."

**Minera Andes (MNEAF.OB).** "Our research indicates that the company's interest in its San Jose project alone has a value exceeding current trading levels. Sizeable upside potential still exists."

Instead, the firm survives by letting the companies it writes about pick up the bill. "We charge the client to write the research," says Strong. "And if it's done right, it will not only play in Peoria, it will play well on Wall Street. It will give everyone what they're looking for: good information, the risks, fair representation of the company."

Needless to say, such a close connection between the issuer as client and the issuer as subject of coverage has raised eyebrows in an industry traumatized by Eliot Spitzer's war on conflicts of interest, but the paid-for players have taken strict measures to keep their work as independent as humanly possible.

## **CREDIBILITY AND QUALITY**

"Essentially, the goal of a respectable organization is good research," says John Dutton, a longtime analyst who pioneered the issuer-paid model by founding now-globally-based J.M. Dutton & Associates eight years ago. "There's no difference between ourselves and a brokerage house in that respect. It doesn't matter how you're paid; that shouldn't influence the quality of the research."

Another early adopter, Taglich Brothers, illustrates both points perfectly. The company happens to be a fully NASD-regulated brokerage firm that started letting micro-cap companies subsidize their own reports in 1999. Beyond that added revenue stream underwriting the added coverage, the model (and the burden of credibility) is exactly what any Wall Street firm delivers -- if not better. "Our analysts are told to make their

best guess of the future...blows away everybody else, the numbers speak for themselves," says Mike Taglich, the company's president. "When we started, people had questions about the credibility, but when your performance blows away everybody else, it's like you don't need to make any excuses."

The performance is indeed impressive. Over the last three-year period, Taglich ranked fifth out of 109 research outlets tracked by Investars with a hypothetical portfolio return of 91 percent. Dutton came in eighth, bringing in a 73.19 percent aggregate return. By comparison, the best performer of the bulge-bracket set, Goldman Sachs, didn't even make the Top 20, and the returns shrink dramatically from there.

"If you go through some of the big firms, they've done very well in terms of research performance," says Dutton, who has voluntarily embraced the NASD's analyst regulations. "If you look at what I'd call the second level, the firms who are big in pipes but more regional than national (but still well-known names), research performance is at the bottom for many of them."

Taglich is more direct. "Writing a research report is about guessing what next year's going to look like. By and large, we've done that better than just about anybody else. Our analysts' charter is to tell what they think the future will be."

## **A BALANCED PORTRAIT**

RedChip Resources isn't ranked by Investars, but the company's efforts to ensure that investors would actually find its research useful are representative of other paid-for firms' attention to transparency as well as accuracy.

"The biggest concern with paid-for research has always been whether that research is biased," Strong explains. "We asked the buy side, if we could overcome that concern of bias, what would be the most important thing for you in this kind of research? To a person, they said, 'Give me the risks.' It's not unlike meeting a realtor. What's important to a realtor is of course location, location, location. On the buy side, you want to know the risks."

It's the disclosure of risk that differentiates an issuer-sponsored research report from the glossy puff pieces that some investor relations shops churns out, Strong says. "If the frog is bumpy, he's got his warts." RedChip's team of analysts presents those warts in terms of the "challenges" that each corporate client's management team must overcome in order to achieve their business objectives. This gives prospective investors the balanced view they need to make an informed decision while cushioning the impact of what the issuer may see as negative coverage with a significant price tag attached.

"If you combine factual data with a look at the issues management faces, you have something that is of value to both sides of the equation," Strong says. "The company receives value because our analysts have taken a look at it in terms of its investment risk profile. We tell management the issues they need to address in order to become more

fully valued. On the other side of the equation, you have provided good fundamental data to the buy side that they can incorporate into their models and determine whether or not this particular equity fits their portfolio."

A more recent entry in the paid-for arena, New York-based Spelman Research Associates, takes a similarly use-oriented approach to its coverage, but company president Guy Cohen notes that the question of bias is fundamental to a research shop's long-term brand viability.

## **PAYING FOR A SELL RATING**

Spelman has its share of "neutral" and even "sell" ratings on the books, while Dutton and Taglich have been equally unsparing with their downgrades. Some issuers do in fact retaliate by cutting off their underwriting relationship, but what's amazing is that many CEOs simply accept that the analysts are actually painting an accurate picture of their company's potential and problems.

### **Spelman Research: Top Picks**

**International Fuel Technology (IFUE.OB).** "Recent developments in terms of distribution agreements will continue to sustain the stock price momentum. Moreover, we consider that if the oil prices will remain at the same high level, then this might be a perfect revenue catalyst for such companies like IFUE. We believe recent profit taking activity is impulsive and imprudent."

**DynTek (DYTK).** "Acquisitions are likely to have an incremental impact on revenue and earnings. Apart from providing exposure to the Southern California market, ITI and Redrock acquisitions also enhance DYTK's product offerings."

**VOIP Inc. (VOII).** "VOII has launched the eGlobalphone service in key metropolitan markets [and] management plans to have its service available in 200 large markets by the end of 2004. We believe that VOII will continue its aggressive rollout program well into 2005, and shall start to see the resulting benefits through new customer acquisitions."

Generally, a company without that kind of upside isn't going to be paying \$20,000 to \$35,000 a year to have an analyst write even the most flattering reports, the paid-for gurus agree. After all, any decent money manager is going to want to crunch the numbers

and kick the tires personally before taking a chance on a small-cap unknown, which would negate the publicity value of the initial paid-for coverage.

"If you're perfect and you have no problems, you are fully valued," says RedChip's Gary Strong. "What we want, and what the Street wants, is to hear where a company can improve. It does a company no good to put their head in the sand. It's important for companies to realize it's more in their interest to have a credible and honest assessment so they can talk about solutions to their problems when potential investors come around."

Besides, these firms don't have the analytical resources to waste on covering lackluster stocks. John Dutton says he turns down about a third of the companies that approach him, while other paid-for firms extensively interview potential clients to see whether a fit exists.

"We tend to have companies with good stories," says Mike Taglich. "We work very hard to get these stories out when we think they're real table-pounders."

## Taglich Brothers: Top Picks

**Laserscope (LSCP).** "They design and manufacture and market a complete line of advanced medical lasers; their most important product is a laser that has practically perfect results in vaporizing enlarged prostate. It's growing 30 percent a quarter."

**Daxor (DXR).** "It's thinly traded but has an excellent balance sheet. You're basically paying for the story, which is an FDA-approved machine that will tell doctors what your blood volume is. Historically, doctors guess, but they're only right about half the time. When they guess wrong, they can easily give you the wrong medicine, which can kill you."

**Reliv International (RELV).** "A manufacturer of nutritional and fiber supplements, weight-management products, soy-based functional foods and a line of skin care products to help reduce the signs of aging. On a year-over-year basis, Reliv grew its net sales in the U.S. market by approximately 22.7 percent."

**LJ International (JADE).** "A vertically integrated fine jewelry company that counts among its customers 27 of the top 40 jewelry retailers in the U.S. The company continues to exhibit a strong

balance sheet."

And if a client complains, both parties always have the right to terminate coverage. "The client does get to read the report to check it for errors of fact," Gary Strong says. "But they do not get the luxury or privilege of changing the analyst's opinion."

Meanwhile, several firms offer more than just a quarterly research report for their clients' dollar. RedChip holds well-regarded investor conferences as well as executive workshops to train CEOs in the mysteries of investor relations, and the firm's wart-focused approach effectively doubles as strategic consulting work. A recent conference Dutton hosted to give its clients face time brought in "about 225 to 230 institutions," and Taglich Brothers goes out of its way to make sure covered companies get the proper exposure to potential shareholders.

"When you're an issuer, you want everyone to know your story," explains Mike Taglich. "We have salesmen whose job it is to ensure that professional investors get a chance to meet these companies when they're in town. That's their job. There's nothing like meeting management, especially for the institutional investors."

## **BUILT TO LAST**

While the industry mulls the paid-for players' performance and efforts to insulate themselves from bias, many young research shops are voting with their feet to adopt the model. Spelman launched just two years ago, and another firm, Vancouver's Fundamental Research Corp., opened for business in June 2003.

### **Fundamental Research: Top Picks**

**VHQ Entertainment (VHQ.TO).** "An excellent contrarian value play that operates 60 video rental outlets in small towns where it's not competing against Rogers and Blockbuster. They also have the same online rental model as Netflix."

**Conn-Space Communications (CCB.V).** "They manufacture communications equipment for people in confined locations. It's a niche market but they're the only company in it. They're trading at eight times earnings, which is a pretty low multiple for a profitable niche operator."

**China Venture (CHV.V).** "A play on China that focuses on education in China. What's exciting about them is they're coming out with an online initiative"

while the government is revamping the entire educational system. Steady revenue growth, but still a more speculative pick."

Like its more established counterparts, FRC has strict disclosure rules and hiring requirements (CFA candidates or designates only) and is currently being developed as an MBA program case study in the application of theory.

"After the global Wall Street settlement, people really came to realize that investment banking and research don't go together," says Brian Tang, FRC president. "So people came up with a better business model that lets research maintain independence."

The segment's older hands are even tougher on the prospects that traditional sell-side research will survive, even at the bulge bracket firms. "Sell-side research is not going to cover thousands of stocks any more," says Guy Cohen. "It's not going to grow, it's only going to keep on shrinking."

In fact, as trading fees plunge toward zero throughout the industry, it simply no longer makes sense for a large brokerage house to pay an analyst to watch thinly traded stocks that bring in even less of the shrinking commission base. And now that research can no longer pay its way as a tool of the investment bankers, the prospects look grim.

"The wirehouses at this point are in the business of overcharging individual investors for pedestrian, generic mutual fund allocation," says Mike Taglich. "The Street's going to shrink, and we're going to grow. They'll be some adoption by larger firms of our model, but as much as anything else, the larger brokerage firms are going to turn more into hedge funds and trade against their customers."

Meanwhile, John Dutton sees the mid-tier brokerage firms abandoning the research function altogether. "The industry is evolving, God knows where it goes," he says. "At some point, the regional firms will go out of research. They're making nice money in sales, trading, money management, banking. They have good brands. Some will look at spending an extra \$8 to \$12 million a year carrying research. Is it necessary to the brand? Possibly some will contract out to firms like ours."

### **J.M. Dutton: Top Picks**

**International DisplayWorks (IDWK).** "Strong buy. International DisplayWorks has created a track record of performance that is now beginning to attract blue chip clients at a time when demand growth for their products is accelerating."

**TMSF Holdings (TMFZ.OB).** "Strong speculative

buy. TMSF Holdings' strong third quarter is the direct result of its change in strategy to shift mortgage underwriting into the Alt-A mortgage market (higher risk loans in which the collateral custodian has not yet received the related loan documents), and other niche products."

Dutton doesn't blame the Spitzer settlement or the bear market chill of 2000-2002 for the downfall of sell-side stock research. To this veteran analyst, it's a matter of long-term economic forces.

"When I started in this business, the commissions were 40 cents per share, back in the '60s. While some people still claim they get four or five cents a share, I think those days are history. You can't do a whole lot on a penny and a quarter, but we don't have to worry about commission flow or deal flow. We can go back to picking good companies to cover and then being right about where they're going."

## **EVOLVING MODELS**

Already, paid-for business models are differentiating as each firm finds its niche in the new industry landscape. Dutton and Spelman are doing a lot of work overseas; Dutton in order to capture the underserved ADR market, Spelman to attract junior talent that can do the day-to-day number crunching (only CFAs sign off on the final reports). FRC derives some of its revenue from subscriber fees, while the other firms simply distribute their coverage for free to hit the broadest possible audience. Taglich is primarily a full-service brokerage firm that receives what Mike Taglich calls "not an enormous number" of dollars from issuers to break even on its micro-cap coverage. And RedChip works closely with agencies in the IR space.

All the players agree that the small end of the market is where real value is created, and that this is exactly the space where Wall Street has stopped looking out for institutional clients.

"The world doesn't need another Microsoft analyst," says John Dutton. "Research is a function. We all have a function to serve, and I don't care whether you're Goldman Sachs or Dutton or Taglich, what people are looking for are certain things: ideas."

Given the growing number of firms getting into the issuer-paid space, is there a wave of consolidation looming on the horizon? Guy Cohen from Spelman says the possibility exists, but not before the market learns to distinguish good research from bad.

"I don't know if the industry's really going to consolidate," he says. "One of the problems is that there's a very low cost of entry. When the business starts to boom, what happens? A lot of new people enter, but a lot of the newcomers aren't qualified, and that lowers the

overall perception of what pre-paid research is. I think we're going to go through that stage first."

When that happens, John Dutton simply trusts the quality of his product. "The issue should be that there's good research out there, and investors will use the best research available. You can't keep good research a secret. If somebody writes a report, it's going to get out."