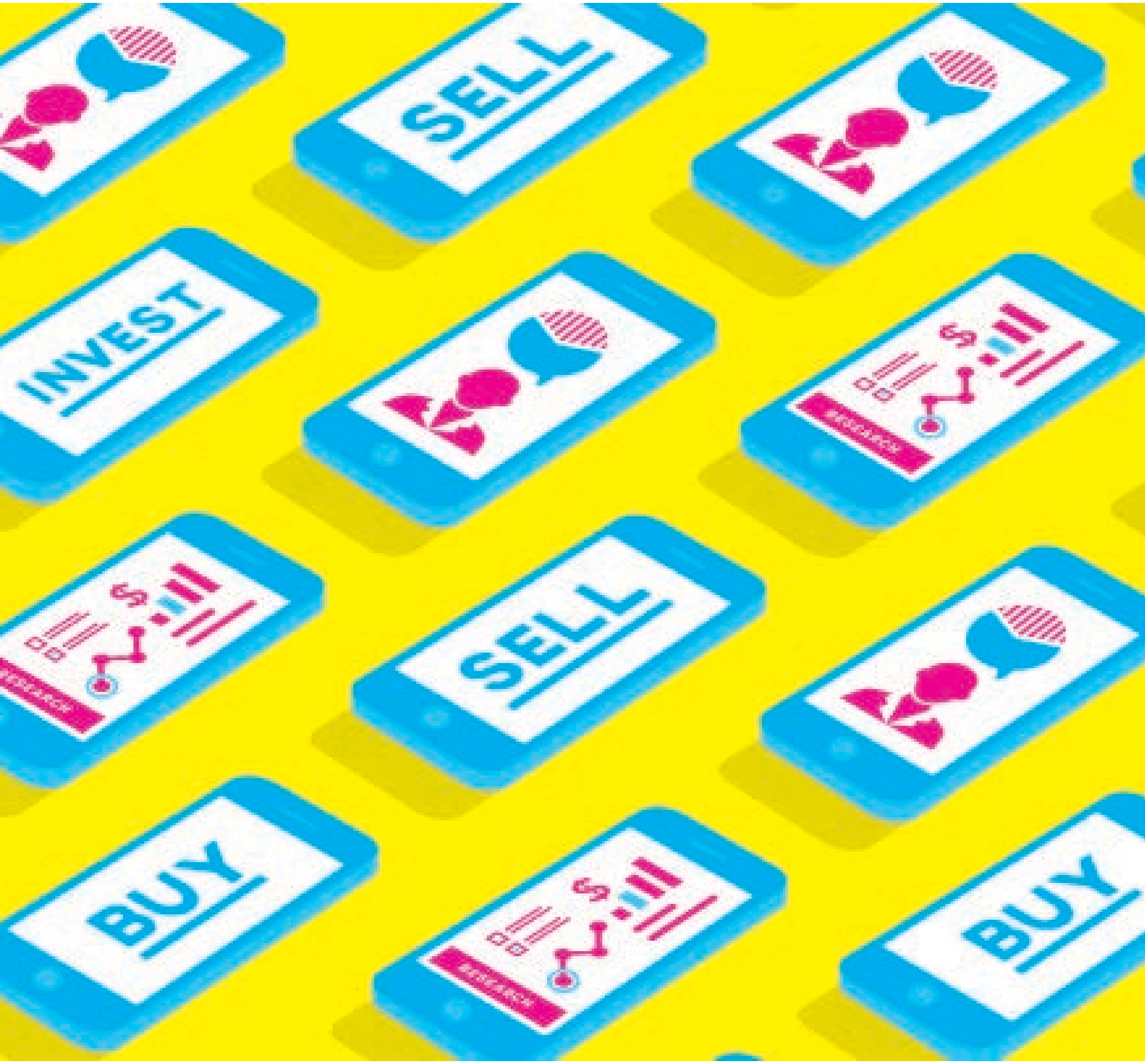
Feature

MIFID II DISRUPTS RESEARCH REPORTS



Illustrations by Rohan Cain

New European regulations are shaking-up the way local and global investment banks produce research on listed businesses. The onus is on IR teams to get in front of incumbent and new players to ensure their businesses continue to receive coverage.

By Alexandra Cain

Change has been a long time coming in investment research. Until now, investors have received research on the stocks they own for free. Magically, reports would appear in their inbox each day, detailed notes recommending whether they should buy or sell a stock they could draw on to make their investment decisions.

That's all set to change thanks to the European Union's Markets in Financial Instruments Directive, known as MiFID II, which has serious implications for local listed businesses. The new rules came into force in January this year.

MiFID II is a wide-sweeping legislation designed to reduce inducements to trade with a certain by broker by offering research or other services and thereby ensure trading is based on a decision of best execution.

Specifically, it requires asset managers to separate research from trading. "The decision about what research to buy should be entirely separate from a decision about what broker to use to execute the trade," explains Clare Witts, head of relationship management, Asia Pacific at financial technology company ITG.

Additionally, MiFID II research must be priced. "Asset managers need to put a value on research in advance of receiving it, and the amount should be uncorrelated to the amount generated through trading," she advises.

While the laws specifically apply to European asset managers and brokers, given most are global in nature, local outposts are following the directive.

On the front foot

Sarah McNally is the investor relations manager for ERM Power, which has a market capitalisation of $460 million. She takes a proactive approach to attracting investor attention. "It's not commercially viable for the major banks to take us on roadshows. The ASX 100 struggle to gain traction in a competitive global investment market so as a smaller but growing company we really need to think laterally and do the legwork ourselves to attract interest from offshore investors."

The business currently has three sell-side brokers producing research, Macquarie, Morgans and JP Morgan, two of which were involved in its IPO. "ERM Power is the third largest electricity retailer in Australia. Investors are interested in us because we have a big stake in the industry, so analysts cover us," she says.

McNally is proactive in her approach. "We have a target list and we go directly to those people, and then use brokers to assist with that. But we do a lot of the briefings and the generation of interest ourselves."

In a MiFID II world in which it makes less sense for brokers to cover small listed businesses, it will be more important than ever for small cap stocks to build a very targeted list of investors to court.

"We have also noticed sell-side research analysts now cover multiple industries or geographic regions. This means they don't have the resources they once did to cover as many stocks across the ASX," she adds.

"Asset managers regulated in Europe need to comply with new rules to pay for research. Some are using research payment accounts or commission sharing arrangements, which is a structure whereby they trade with a broker based on a fixed rate for execution. Then they add a credit over the top that can be used for research. The other option is fund managers pay for the research out of their own pockets," says Witts.

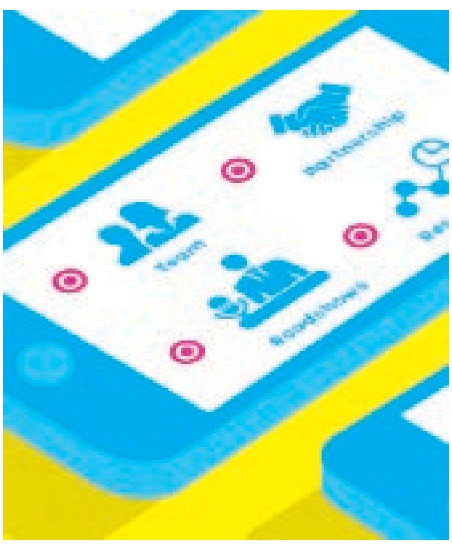
"The significant point is that when a fund manager trades with a broker, the investors' money is used to pay for those commissions. Under MiFID II if investors' money is used to buy research there are rigorous requirements about the processes and disclosures for doing so. So in Europe a large number of fund managers have made the decision to pay for research out of their own P&L, their own money, rather than using investors' money," she explains.

The focus on explicitly pricing research has changed the commercial dynamic between brokers and asset managers. For both the buy- and sell-side, it's about understanding how much they are being paid or are paying for research and what that means for that commercial relationship.

Says Witts: "It has forced brokers to review how much their research costs to produce and removes the ability for a large broker to cross-subsidise research from different business lines."

Tell 'em the price

The cost to produce, as well as the price and value of research, has been one of the most intense discussions as MiFID II has come into force. "Reviewing the amount paid for research forces asset managers to take a long hard look at what they value. There is plenty of high quality research that delivers value to a portfolio manager's decision-making process and they do want to pay. But we hear feedback that there is also a lot of commoditised research, and in some cases clients have noted the 'juniorisation' of bank research departments as cost pressures intensify. Now they won't assign value to research they don't want or don't find useful," says Witts.



She says as MiFID II has played out, some asset managers' research budgets have risen to ensure they continue to receive the research they want. In other houses, the research budget has shrunk.

"There is concern about a significant drop in research spending globally. So far what we have seen in Europe and also now in Australia is far clearer commercial conversations going on between the buy side and the sell side about what they want to receive and how much they are willing to pay. Previously, a fund manager may have received 20 reports a day in sectors in which they may or may not have been interested. Now they need to indicate they want to receive research and what they receive is more relevant," says Witts.

Jon Foster, co-founder of independent research platform Smartkarma explains how this dynamic works. "The cost of producing research for banks is very high, given large salaries and the complexity and management structures in banks. So, the price they have to charge for research is very high. And investors don't want to pay. That's what's happened in Europe, that's what's happened in Asia and that's what's happening everywhere."

In terms of their business models, there is an expectation some of the large brokers and investment banks will be able to maintain what they call 'waterfront coverage'.

"They will still provide multi-sector, multi-style research. But the number of providers that can afford to do this will shrink and we'll end up with more specialist research providers," Witts adds.

It's expected local brokers will specialise in certain areas.

It has been reported State Street Global Advisers is absorbing research costs. While Union Asset Management's Alexander Schindler, a previous president of the European funds association, has been quoted claiming asset managers are expected to drop their research budgets by 30 per cent.

It's understood MiFID II has the support of the superannuation sector, which appreciates added insights into how the commissions they pay to brokers are used. This is especially important to this community, which is tackling its own regulation, RG 97, to make fees and charges in the sector more easily understood.

Top tips

Rand Low is a New York-based University of Queensland (UQ) Business School honorary fellow with a specialisation in financial instruments. He has four tips for IRs transitioning to the new MiFID II regime.

1

Invest in your team. Hire sell side analysts who have strong existing relationships with buy side firms. Focus on hiring individuals with strong networks with firms that have not traditionally invested in your business.

2

Do roadshows. Understand the forums and international conferences asset managers and investment managers attend and ensure you have a presence to exhibit and present your firm's strengths and activities. Rather than wait for analysts to come to them, smaller listed businesses will need to actively present and market themselves to investors.

3

Partner with brokers. Work with boutique small-cap research houses, and also with larger brokers that provide research to specialised small cap fund managers and larger institutional investors.

4

Commission independent research. Consider commissioning boutique investment and consulting firms to perform independent research on your business activities and make this information publicly available. Ensure the commissioned research is an objective investment thesis to avoid any perception of conflicts of interest.

The bottom line

In terms of what all this means for investor relations, the long tail of small cap companies that already fight to get brokers to publish research on their businesses are likely to struggle even more. Witts' advice to IR teams is to have a clear understanding of their existing commercial relationships with brokers and identify specialist research houses that may be open to covering the business.

"In other regions corporates are building a deeper understanding of their investor base themselves, rather than relying on a broker," she says.

MiFID II is also disrupting the way research is produced. Very soon, research is likely to look quite different to the way it looks today. Research issued by investment banks has come in basically the same text and charts-based formula for decades. The digital age renders this obsolete and in the future research is likely to be delivered in new formats such as videos and short-form text, produced in a way that's easily digestible on smart phones. This is something for which IR teams should be prepared.

"There's also talk in Europe about more issuer-backed research being produced, where corporates work with independent providers that do a certain level of due diligence on businesses, but the research is paid for by the entity being covered," says Witts.

Additionally, analysts' KPIs are likely to be a lot higher now because investors are now getting a bill for their research. Some of the big brokers are likely to lose analysts – healthcare veteran Andrew Goodsall has left UBS to join MST Marquee.

MST Marquee has developed an independent research platform. CLSA in Asia is another example of a business that provides independent research.

"I think we're going to see a cottage industry develop. Investors are going to buy research from one firm and trade with whoever gives you the best price," says Brett Evans, managing director, Atlas Wealth Management. Evans says for IR people, MiFID II means a return to past practices. "They are going to have to pack their bags and do roadshows; which is the old school way. They need to showcase the business, as opposed to hoping an analyst will pick them up, and get exposure that way."

He anticipates there's an opportunity for specialist research houses to organise roadshows for groups of small- and mid-cap businesses as part of their service. "The only way they're going to get true exposure to offshore investors is by going to sit in their boardrooms with a PowerPoint presentation explaining who they are and what makes them tick."

Evans says the doomsday view that MiFID II will mean European investors will walk away from Australian investments because it won't make financial sense to produce research on them is short sighted.

"There are still very good reasons for investors to be in this market. If you want a mature market to get access to resource stocks, Australia is still the pick of the bunch. But investor relations has to realise investors are not just going to knock on their door and say, 'hi we're from Frankfurt or Paris, we'd like to invest in your company. So they need to get out there and be visible."

It's also important for IR teams to explore the new ecosystem of independent research firms. "This is going to be an increasingly influential part of the market. They need to make sure that they are exposing themselves to new players, who will have increasing influence with global investors," says Foster.

"Things can change fast. If you look at the big shifts we had in the 80s with banks, it doesn't take them long to close a research department. So if you're not in front of new players, you're not going to be exposed to one of the most influential parts of the puzzle. This is not a wait-and-see for IR departments, because they may look up in six months and find no-one covers their business, especially small companies," he warns.

Foster says the idea is to view MiFID II as an opportunity to have a much more interactive and private relationship with investors. "We're moving from a world that has been controlled by institutions to a new normal where information sharing is decentralised."

For IR professionals, MiFID II is an opportunity to re-think the way they identify and communicate to new and existing shareholders and consider how digital tools may be able to compensate for previous analyst coverage.

Business as usual for top IRs

Although MiFID II will change the way the buy side and sell side interacts with small listed entities, some firms are already well prepared.

"From our perspective, there's not going to be a huge impact. The internet was probably a bigger disruptor of research coverage. Online brokers triggered a race to the bottom for brokerage. This meant otherwise-good companies were not attractive from a research coverage perspective if trading volumes were not there generating even less brokerage remuneration," says James Powell, investor relations and distribution manager, Rural Funds Management, an agricultural property trust manager.

Four brokers cover the business at the moment, as a result of Powell running a proactive IR program. "I contact brokers that cover our or complementary sectors," he explains. "In some cases it's also been logical to involve them in corporate activity."

Powell expects all four to continue to produce research over his business. "If a research department is independent, commercially accountable and viable as a stand alone business unit, that's exciting for small- to mid-caps. In terms of satisfying paid subscribers, researchers will be looking for companies with good ideas communicated clearly. It's an exciting opportunity for IR managers, as it enhances our function in the business as well as in the market overall."

From a practical perspective, he says IR teams will need to ensure they have a robust disclosure strategy. "It's about being clear communicators and accessible to the market. It's really important for IR managers to articulate the strategies and story of the companies we represent."

Although brokers may have organised roadshows in the past, Powell says there's an inherent authenticity when IR arranges meetings.

"From authenticity comes rapport and from rapport comes trust. You end up with a stronger relationship with those on your register and that can be a real advantage. This is particularly true if you have to approach them, at some point, about results not achieving expectations or some other adverse thing."

He says it's also important to talk to fund mangers that do their own research and that brokers still have a role to play. "There won't be cataclysmic change, particularly for small caps. I think IRs should see this as an opportunity and re-look at the way they approach research and the market."