Why broker research coverage of non-clients is collapsing

By Jason Streets, Hardman & Co

Cenkos profits plunge 91% as small-cap fund-raising dives
Fast FT

Source: Financial Times

Many commentators realise that the traditional institutional broking model is no longer sustainable. However, the reduction in the quantity of non-corporate coverage that has already occurred, even before MiFID2 comes into effect, will still come as a shock. The evidence shows that there is no commercial sense in brokers covering non-corporate companies with less that £200,000 daily turnover in their shares.

Let me own up. In the not too distant past I was Head of Research at one of the more successful mid and small cap brokers. I have also been an analyst at 'bulge bracket' investments banks and even a fund manager. Thus I have seen the way in which the role of the research analyst has evolved over many years, as well as personally experiencing the challenges of running a research department.

In the golden era of equity analysts, the 1990s, managing a team of analysts was famously likened to herding cats. The ideal analyst was smart, individual, possibly quirky and not too keen on being told what to do. Starry analysts were a must have for any investment bank and, though expensive, were affordable. Since then the additional burden of heavier regulation and the unceasing shrinkage of equity commission rates means employing a galaxy of top rated analysts is only affordable by the richest banks.

For the smaller houses, typically focusing on small and mid-sized companies, the shrinking commission pool means having another look at the business model.

Banks face $5bn hit to research teams as asset managers cut spending

Source: Financial Times

In the past, commissions (and trading profits) would have paid the overhead costs including salaries and the fatter but lumpier sums that came from primary business (IPOs and other equity issues) would have filled the bonus expectations. Now corporate revenue is needed just to break even.

In 2007, Panmure Gordon, one of the City's most venerable institutions was able to say this:

"The UK business model is that, in all bar the most extreme market conditions, all pre-bonus costs are covered by institutional equities and retainer income. We are therefore not dependent on corporate finance transaction income to meet costs."

Source: Panmure Gordon Annual report 2007

By 2015, the clouds had darkened considerably:

"The Group experienced a number of pressures and as a result has entered into a £4.1m post-tax operating loss ... This loss was due to a reduction in corporate finance and other fee income by £7.9m to £12.8m."

Source: Panmure Gordon Annual report 2015


UK brokers: small problem
A fragmented industry in a business where size matters
Lex

Source: Financial Times

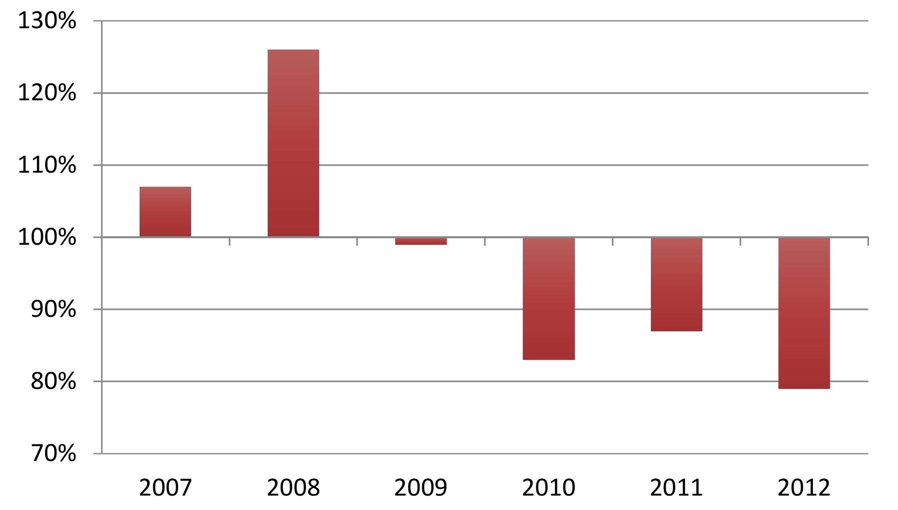
And Panmure is by no means alone. Possibly the most successful of the medium sized brokers, Numis, had a similar angle in 2007:

"It is also extremely pleasing to note that recurring income, comprising that derived from secondary sales and trading, corporate retainers and net interest and similar income has increased by 68% from £24.0m to £40.4m and now covers 107% (2006: 87%) of our continuing expense base before non-recurring property costs and performance-related pay."

Source: Numis 2007 annual report

A few years later the recurring income story had lost its shine and it wasn't mentioned again after 2012.

Numis recurring revenue as % of operating expenses



Source: Numis annual reportS

This means that any independence the research department may have had from the corporate business has now gone – the brokers must focus on corporate business simply to keep the enterprise viable.

So what does this mean for how the research department of a small broker is managed? In the past, the head of research of a small broker would always be looking for new analysts. Any good analyst should automatically have been accretive to earnings adding new coverage and hence new commissions. Now he must focus simply on keeping the corporate clients happy at the lowest possible cost – the potential upside of having thought provoking research on non-house stocks is too small to bother with. So in defence he must keep his existing bases covered and in offence he must be on the lookout for analysts who can either attract corporate clients themselves or fill a gap created by the hiring of new corporate financiers


City of London stockbrokers struggle as challenges pile up

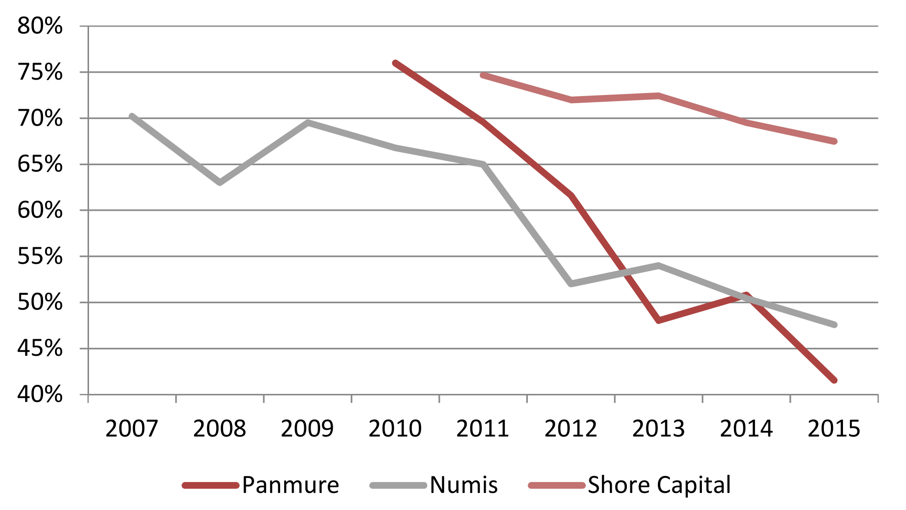
Sector set for consolidation as market volatility and regulation exacerbate cyclical downturn

Source: Financial Times

What sort of analysts will he now be looking to hire? Certainly not the maverick; nobody too expensive (or too reliant on help from juniors); somebody who can keep the corporate clients happy (a few grey hairs perhaps?) and be relied on to get a report out swiftly on any corporate news. That should satisfy the corporate finance department but it won't go down well with the sales force who will want something more tasty to regurgitate to their clients.

And which stocks should the analysts be covering? In the past anything which was interesting might well be worth writing about; today only corporate stocks, potential future corporate stocks and essential comparators of corporate stocks (if you want to follow William Hill, you have to cover Paddy Power and Ladbroke too). One analyst can cover about ten to fifteen stocks – depending on how complex they are and how similar they are to others under coverage. There could be a few more which are only superficially under coverage – erected like Potemkin villages – and analysts might well attend other corporate meeting with no intention of taking up coverage (unless the brokerage comes up for grabs) but simply to get more industry information (perhaps they are suppliers or customers of companies under coverage).

Non-Corporate stocks as a percentage of stocks covered



Source: Company Annual Reports

The head of research will constantly be badgered by the corporate department to cover more stocks – in particular ones which the bankers think, realistically or not, they have a chance of winning as clients (though some think that post MiFID2, brokers will be banned from sending research on non-corporate stocks out for free as it will be considered an illegal 'inducement' to trade'). He will also be pushed back when he suggests that some corporate minnows should be let go as it takes too much analyst time to cover them. We only need two notes a year, they don't have to be long – he will be told. Missing the important point that if you are an analyst following a stock you need to keep an eye on the company, the industry and its competitors 24/7/365. And he has a budget…

Stockbrokers: an endangered City species

The days of easy money may have gone for ever for firms such as Panmure Gordon

Source: The Sunday Times

If the typical analyst salary in a mid-tier broker is, say, £100,000 then the total cost of the analyst (after paying for data, IT, property, NI etc.) will be roughly double that. If you then have one salesman per two analysts – and they cost about the same – and the analyst covers ten stocks then the cost to cover one stock is £30,000 per year. This ignores the cost of the corporate department, the back office (including compliance and HR) and the market makers (whom you hope pay for themselves).

The basic maths of a mid-cap broker's secondary business

Secondary Team Cost	
Analyst Team	
No of analysts	20
Average remuneration	£100,000
Associated costs per analyst (IT, property, data, NI, overheads)	£100,000
Full cost per analyst	£200,000
Total analyst team cost	£4,000,000
Sales Team	
No of salesmen	10
Average remuneration	£100,000
Associated costs per salesman (IT, property, data, NI, overheads)	£100,000
Full cost per salesman	£200,000
Total sales team cost	£2,000,000
Total secondary team cost	£6,000,000

Source: Hardman & Co Research

In 2015, the average FTSE250 stock traded about £2.4m per day. The average FTSE small cap (that is the next 280 fully listed stocks below the FTSE250) traded about £100,000 and the average AIM stock traded about £50,000 per day.

TEMPUS: THE FUTURE OF STOCKBROKERS

SEPTEMBER 3 2016, 12:01AM, THE TIMES

Brokers mull over the end of an era

Source: The Times

Assuming a commission rate of 15bps – that equates to under £20,000 a year for the average AIM stock and less than £40,000 for a small cap. If you can take a 40% market share, that would equate to commission income of just £7,500 and £15,000 respectively.

Of course these are averages and the brokers will be trying to concentrate on the larger stocks in each category. On the other hand, 15bps is probably a generous assumption and to win 40% market share in a non-corporate stock is hopelessly wishful thinking. The clear message is that it makes absolutely no commercial sense to cover a stock which trades less than £200,000 per day.

Minimum trade required for commerciality

Coverage cost per stock	
Stocks per analyst	10
No of analysts	20
Total no of stocks	200
Minimum annual commission per stock for breakeven	£30,000
At 15bps commission equates to annual turnover of	£20,000,000
Assuming 40% market share, stock must trade annually	£50,000,000
Equivalent to trade per day	£200,000

Source: Hardman & Co Research

Shrinking coverage to primarily brokership stocks presents another headache for the head of research: he is likely to find that there is a preponderance of buy recommendations. There is not going to be much he can do about this, as anything less than positive is likely to jeopardise the client relationship that is now the raison d'être of the broker. These issues have always existed but they are simply going to be more evident now. We might see some more tinkering with ratings – it is useful to have two sorts of "Buy" rating so you can signal to professional clients that a corporate stock is no longer on the highest rating. We might even see a return to favour of the "Buy on weakness" rating that sounds positive but is actually indicating that you believe the stock will be weak.

And the headaches aren't entirely over for the beleaguered head of research. With largely corporate clients under coverage who have to be kept happy, he now finds he has to convince his asset manager clients that his research is still worth paying for. This will be difficult but not impossible.

Gone are the days when fund managers would ring the analyst for the real story on a corporate stock. The shareholders will have a dialogue anyway with the company but might probe the analyst for the sensitivity of his forecasts to different assumptions and other industry knowledge (which they will pay for); non-shareholders are just unlikely to hear from the analyst if there is a story he's not so keen on and the research note will quickly be swallowed up in the avalanche of paper (electronic or physical) that descends daily on fund managers' desks.

Is it going to get any easier? Whether MIFID2 is implemented in its current state or not, the trend towards asset managers' paying for research themselves, rather than with commission from client trades, looks irresistible. Consequently, downward pressure on commission rates is likely to persist, squeezing brokers still further. The head of research will have to let a few more analysts go, reshuffle the coverage of corporate stocks including to non-sector specialists, and reduce the non-corporate coverage still further. This model will struggle to survive except when times are good and the corporate fees are flowing.

For the poor, beleaguered head of research, who is now also covering more than his fair share of companies, the only silver lining is that there are more stocks he can deal in personally as the firm's coverage shrinks. The downside to that though, is they tend to be the stocks he doesn't know anything about…

About the Author

Jason has recently joined Hardman to boost the coverage of the consumer and leisure sectors. Most recently he was Managing Director of Jefferies, and its forerunner RBS. Previously he was Head of Research at Evolution Securities (now part of Investec), leisure analyst at UBS investment bank for nine years. Following an MA in Law from Cambridge he started his career in financial services as an institutional fund manager.

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