

CFO Magazine

The Flight of the Sell-Side Analyst

Small-cap and mid-cap companies -- and some large companies, too -- are suffering through a drought of sell-side analyst coverage. The dearth is moving some executives to think about bypassing analysts altogether.

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Sell-side analysts are fleeing smaller issuers, leaving executives at those abandoned companies to fend for themselves in dealing with large investors. Indeed, analysts who work for the sell-side research units of large brokers and investment banks are heading en masse for the economic shelter of large-cap companies.

The reason for the exodus? Large-caps boast heavily-traded stocks — and their whopping fees. The movement to big-company stocks has, however, been spawning a large share of losers. According to Reuters Research, there's been a 13 percent increase in the number of companies that lost sell-side coverage completely since 2002. The researchers calculate that 666 companies of the 4,075 in its database had been "orphaned" by sell-side analysts as of January 2004. Two years ago, only 85 companies were left without analyst coverage.

Most of the new orphans are small: 97 percent of the companies left without analyst coverage this year have a market cap under \$1 billion. The bulk of the remainder consists of big-caps that lack heavy trading volume. All but eight of the 19 large-cap companies that lack coverage came in under 1 million shares of total volume over the last 10-day period ending July 1. By way of contrast, heavily covered giants like Microsoft Corp., General Electric Co., and Ford Motor Co. traded between 90 million and 500 million shares during that same period.

The effects of the analyst migration extend beyond the orphans to those companies that are hanging on by a thread. Reuters reports that 380 are down to a pair of analysts tracking their stock, while 473 companies have just one. At such companies, executives will surely be under increasing pressure to keep from losing their existing coverage or to replace lost analysts in some way.

That's because decreasing coverage means a dwindling exposure to investors — a situation that makes raising capital difficult. "If you don't have analyst coverage, investors don't really know about you," warns Ashwani Kaul, a senior market analyst at Reuters Research. At the same time, Kaul reckons, the analyst rush to big-caps creates "a void for investors who are interested in small- and mid-cap companies."

Sell-Side Economics

Even if analysts had the will to fill the void, however, the bodies just aren't there. Layoffs and voluntary exits from the sell-side-research business have gone hand-in-hand with a sputtering stock market, explains John McInerney, a senior director at Citigate Financial Intelligence, a communications firm. As a result, the number of sell-side analysts has decreased over the last few years by 15 percent to 20 percent, estimates McInerney, whose firm recently conducted 90 interviews with corporate issuers as well as sell-side and buy-side analysts.

For many sell-side analysts, choosing which companies to cover seems thus to have become a matter of triage. With the analyst force shrinking, individual researchers have been scrambling to cover their existing lists plus those of the departing analysts, according to issuers surveyed by Citigate. They've also had to hustle to cope with accelerated regulatory filing requirements

that force the researchers to squeeze more financial-statement reviews into the same work week.

The situation of fewer analyst bodies doing more work can also lead to "analyst churn." The increased switching of analysts from company to company is the most significant change in investor relations over the past few years, notes Bruce Nolop, CFO of Pitney Bowes Inc. The turnover, he explains, forces the Pitney Bowes investor-relations team to constantly reeducate analysts about the not-so-easily-defined company. A venerable postage-meter manufacturer with a \$10 billion market cap, the company has made a recent foray into mailroom services and outsourcing.

In December 2002, 10 sell-side analysts covered Pitney Bowes, Nolop recounts. But by April 2004, that number had dropped to five — three of whom are still new to the company story, having come on board since 2002. That's left Pitney Bowes with only two veterans, Carol Sabbagah of Lehman Brothers and Shannon Cross, formerly of Merrill Lynch, now with the eponymous Cross Research.

Besides the diminished analyst workforce, Wall Street economics are also spurring shifts in coverage. In effect, the research subsidiaries that employ sell-side analysts aren't self-sufficient. Investment banks and brokerage houses derive operating profits from investment-banking fees and share-trading commissions, not analyst reports. In the end, sell-side research tends to be a loss leader, bundled for clients along with lucrative services.

Thus, it's the fees and commissions that "drive analyst coverage," maintains Reuters' Kaul, "because that is where the money is." He contends that many small-cap and mid-cap companies that have great investment potential don't garner coverage because they don't represent a substantial source of profit for the firms.

Others agree with Kaul's assessment. San Francisco-based investor-relations consultant Peter Ausnit, a former sell-side analyst, predicts that over the next decade, sell-side research sponsored by big financial-services firms will increasingly focus on large companies that support Wall Street's revenue model. Further, analysts tied to big Wall Street firms will soon focus on "only a handful of big-cap stocks that provide sufficient profit margins," predicts Richard Wayman, president of researchstock.com.

Indeed, the focus seems to be shifting already. Multibillion-dollar behemoths like Comcast Corp., Texas Instruments, and BellSouth Corp., for instance, have dramatically increased coverage since 2002, according to Reuters Research. Each of those companies added 11 new analysts over the period, giving each one the coverage of more than 30 analysts.

For the companies who end up losing what increasingly seems like a zero-sum game, however, the consequences can be severe. Sell-side analysts can provide a smooth passage for a company into the capital markets, supplying an imprimatur for investors seeking guidance about which shares to stock up on. Further, many analysts are aggressive matchmakers, introducing institutional investors to the companies they cover.

Witness the good meeting that analysts have given to FuelCell Energy Inc., a \$780 million alternative-energy company based in Danbury, Connecticut. Investor-relations director Steve Eschbach says executives met with more than 65 potential investors during 2003, and equity analysts arranged half of the introductions.

Further, sell-side research can present company deficiencies within a larger company or industry scope. "Sell-side analysts put the bad news in context," says Nolop of Pitney Bowes, noting that most CFOs appreciate that kind of help when investors are skeptical about management's perspective.

Investor Direct

Still, even with all the help analysts can provide to public-company finance chiefs, it's possible to do more with less. That's what executives at FuelCell Energy found when analysts started beating a path away from the company.

Since 2001, 11 of 18 analysts have walked away from the company's stock, leaving the company with a respectable, if dwindling, analyst base of 7. While Eschbach agrees that losing coverage can stifle a company's access to the capital markets, he thinks that quality can trump quantity. The remaining analysts are "very diligent" about arranging investor introductions, he adds.

Nevertheless, the company launched an investor-outreach program on its own to make up for lost coverage. In late 2002, management called in Rivel Research to help ferret out potential investors. The Westport, Connecticut-based researcher identified 24 or so funds that had a keen interest in financing alternative-fuel technology. Eschbach says that the outreach campaign yielded at least one new investor.

Since the drop in coverage, which the investor-relations director attributes to Wall Street's disenchantment with the alternative-energy market, FuelCell Energy also has boosted its in-house peer-analysis efforts. For his part, Eschbach concentrates on identifying new investors, while the company's CEO and finance chief focus on holding on to existing shareholders.

Investor-relations consultant Ausnit views the drop in coverage as a chance to convince his clients — which include Pitney Bowes, Electronic Data Systems Corp., and MacroMedia Inc. — that it's possible to bypass analysts and go straight to investors. One good way to grab an investor's attention is to assign the CFO to lead capital-raising efforts, he says. In that way, the finance chief can cultivate strong, direct relationships with institutional investors.

Not everyone agrees that going direct via the CFO is such a hot idea, however. Most top finance executives don't have the requisite investment-banking background to raise capital in the public markets, contends B.J. Rone, a former finance chief of the semiconductor unit at Texas Instruments Inc. Instead, Rone, now a principal with interim-CFO firm Tatum Partners, would rather see finance chiefs attend to strategic operations and corporate finance — and leave the capital-raising to Wall Street experts. "Very few CFOs are qualified to raise capital," he says.