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Saving Sell-Side Research

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The news on sell-side equity research could hardly be any worse.

Sell side research's investment banking linkage has been constrained as a result of the global settlement with regulators. Its economics are further depressed by decreased trading commissions, which have fallen by approximately 50 percent in the last five years, and by the fact that some buy-side firms are seeking unbundled trading from research. There are also regulatory pressures, led by the United Kingdom's Financial Services Authority (FSA), in transparent reporting of commission-related services. Finally, there's increased buy-side interest in, and sell-side funding for independent research. Industry experts forecast that sell-side research revenues of approximately \$5 billion will fall by up to 50 percent in the next few years.

Despite this bleak reality, Booz Allen Hamilton believes that sell-side firms will remain the dominant research providers to the buy side, even in the face of competition from independent research providers and buy side's own research staff. Granted, industry capacity will adapt to the emerging economic reality: One hedge fund manager predicts that the industry will have "10,000 instead of the current 25,000 analysts." But the sell side's unique strength in research will remain. Leveraging their scale and relationships,

winning research providers will offer new products, services, and distribution formats to best serve buy-side needs.

The Buy-Side View

We discussed buy-side attitudes on research with chief investment officers, portfolio managers, head traders, and heads of research at U.S. and European firms managing assets totaling more than \$4 trillion.

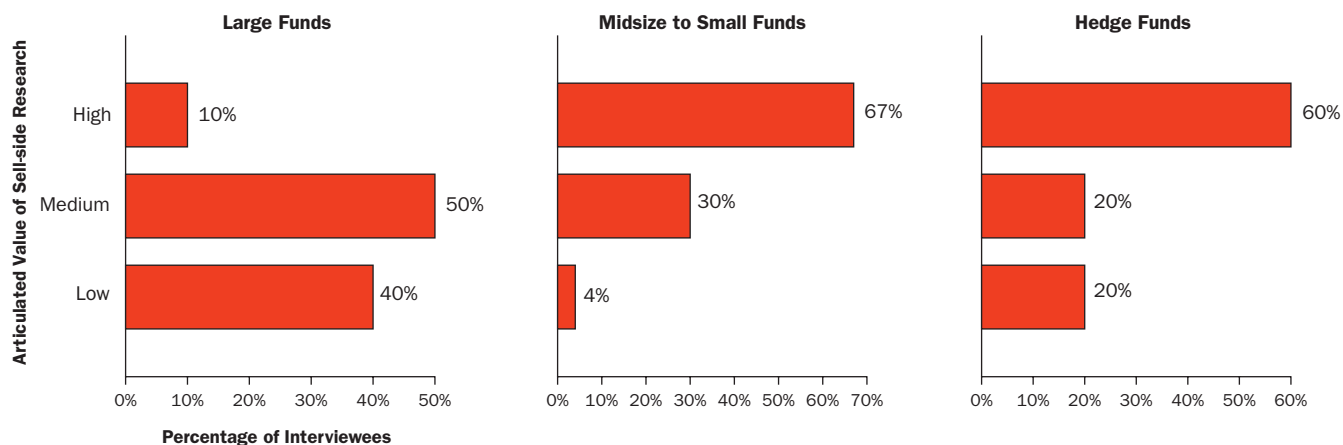
In their view, the basic research product—traditional stock reports—has become an oversupplied commodity especially after Regulation Fair Disclosure (Reg. FD). To quote a portfolio manager, "How much additional insight do you think I derive from the tenth analyst report on the same stock?" Reports were a priority item for less than 20 percent of interviewees.

The real value of sell-side research accrues along three separate dimensions: product, service, and distribution. The research product derives value from its multiplicity of independent data points, sector or structural insights, and breadth of coverage. Good service consists of not only access to top analysts and the companies they cover, but also the responsiveness of the sell-side analyst. Finally, sales teams' customization of research to specific client needs adds value to commodity research and strengthens buy-side perceptions of sell-side research.

Interestingly, while many large asset managers report that they can pick up the phone and call any CFO themselves, sophisticated managers still seek research partners—a role much like that of

Exhibit 1

Articulated Value of Sell-side Research



Source: Booz Allen Hamilton

consultants—in their investment process. They are less interested in analysts “acting like matchmakers” or offering themselves as sources for alpha ideas.

The value that asset managers ascribed to research varies by their funds’ size and strategy. The managers of the largest funds consider sell-side research the least valuable, mainly because of their own internal capabilities. Asset managers of smaller funds and hedge funds regard research much more favorably (see Exhibit 1).

This pattern in value perception is aggravated by the fact that large managers pay (in absolute terms) the most for research, taking into account the size of their commission payments. 70 percent of those managers feel they overpay for research versus only 25 percent of small to midsize funds.

In spite of this perception, and counterintuitively, a majority of asset managers do not seek unbundled research. The main reason is their fear of the consequent impact on buy-side profitability if research has to be paid explicitly from management fees. Other reasons include access to the IPO calendar and, for smaller funds, concerns over research affordability in an unbundled environment.

The Sell Side’s Enduring Strength

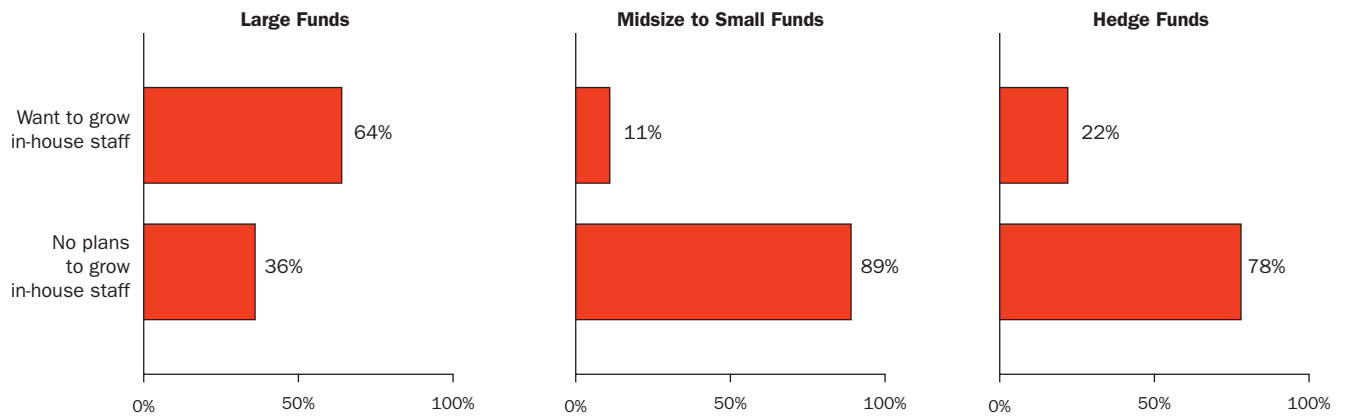
If research remains important but the sell side’s provision of it is questioned, it’s worth exploring who else could step into this gap. Some suggest that the buy side will become self-sufficient on research or that independent research will meet this demand.

The largest buy-side firms (assets of \$100 billion or more) can certainly afford the high fixed cost of having their own research infrastructure (see Exhibit 2, page 3). Indeed, two-thirds of the large asset managers we interviewed want to develop in-house research staff. Similarly, independent firms have been able to develop successful and innovative business ideas, such as expert networks that allow buy-side firms to get direct information from industry practitioners. Some have also expanded into the research outsourcing business; Nordea’s partnership with Standard & Poors is one example.

Still, we believe that large sell-side firms remain uniquely positioned to provide research to the buy side. Most asset managers and independent research firms do not have the scale to match the sell side’s breadth of coverage. Large sell-side firms can spread high fixed research costs over their greater number of clients, and they are already cutting costs to make their production and distribution more efficient. They can also

Exhibit 2

Buy-side Plans to Grow In-house Staff



Source: Booz Allen Hamilton

leverage their broad set of relationships and market color that, even with Reg. FD, create a fertile source for investment ideas. Finally, sell-side firms can best meet the needs of asset managers across all three components of research: product, service, and distribution.

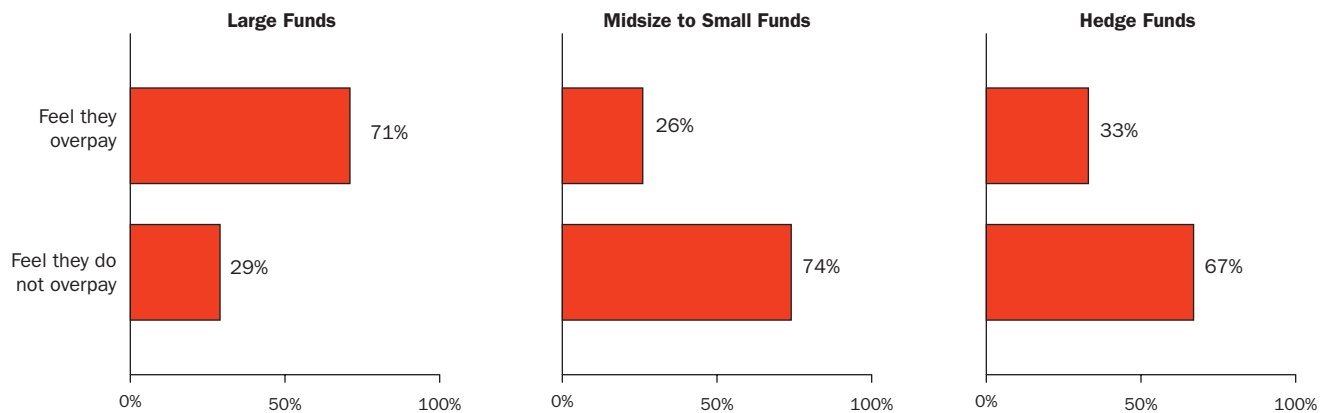
Looking Ahead

Despite the fact that 70 percent of asset managers say they are not seeking research unbundling, and that sell-side firms remain best positioned to provide research, change is likely. This change can take many forms: greater disclosure; analyst-capacity pruning; commission-sharing agreements (CSAs) that, according to Greenwich Associates, 75 percent of institutional investors in the United Kingdom already have in place, or plan to put in place; and at least limited research unbundling, given Fidelity's recent agreements with Lehman and Deutsche Bank to pay separately for research and execution.

However, across-the-board unbundling is unlikely. For hedge funds, it's simply not worth squeezing the sell side on commissions; for smaller buy-side firms, unbundled research impairs their economics. Morgan Stanley estimates that a move to unbundled research will shave approximately 3 percent from average profit margins of asset managers. Therefore, we foresee a mixed monetization model.

With research in a state of flux, it's useful to understand the drivers of future change. Interestingly, most of these are market forces, not regulatory pressure.

1. The willingness of some large buy-side firms to unbundle research from execution has increased investor scrutiny of other buy-side firms. Investors will ask, for example, "If Fidelity's management is paying directly for research, why is my manager paying out of my assets?" Consequently, some asset managers will consider unbundling to compete for large pension fund and plan sponsor mandates.
2. Some sell-side firms may see an opportunity to pick up trading volumes by unbundling commissions. In our conversations with top-tier U.K. firms, we have heard that this is already happening. *TheStreet.com* reported that Lehman gained volumes with Fidelity by unbundling and lowering its commissions. Other top trading desks will come under pressure to match this kind of competition.
3. Increased adoption of CSAs in the United Kingdom will drive price discovery and a greater acceptance of what the Securities and Exchange Commission calls "client commission arrangements." Firms that operate in both the United States and the United Kingdom may use these price benchmarks to negotiate in the United States.

Exhibit 3**Buy-side Perception of Overpayment for Sell-side Research**

Source: Booz Allen Hamilton

Booz Allen expects these drivers to materially alter the sell-side research landscape.

1. We expect overall research spend to decrease by approximately 30 percent in this environment of enhanced transparency. The main driver is not cost pressures on the buy side (see Exhibit 3), but that they can now compare specific research spend across providers and assess redundancies as well as provider quality. This should help drive out the significant perceived overcapacity in research. One asset manager told us, “We already have a core set of 10 brokers, but plan to bring it down to five over the next few years.”
2. The buy side’s continued adoption of more sophisticated broker-evaluation systems will deliver quantitative quality metrics that can help establish or validate research pricing. These systems could take the form of broker voting, third-party analyst-performance measurement, or a commissions-management system.
3. Midsize sell-side firms producing me-too research are expected to get squeezed out, leading to a gradual barbellizing of the research supply curve (see Exhibit 4, page 5).

In parallel, pools of liquidity will migrate upward to the top and middle-tier brokers. This consolidation of execution volumes is already being observed in the United

Kingdom, where CSAs are making it easier to compensate specialist research providers without trading with them. To quote a trader: “I can’t wait to stop dealing with so many brokers—some of whom may botch my execution—only to pay them for research.”

4. Smaller buy-side firms will be competitively disadvantaged in a more transparent world. We think the subsidies to smaller buy-side firms are often overestimated: Though they have access to all the published research, the real value of sell-side research comes from the service aspects, and that is routinely focused on the largest clients. Even so, transparency will further impair research services from the sell side.

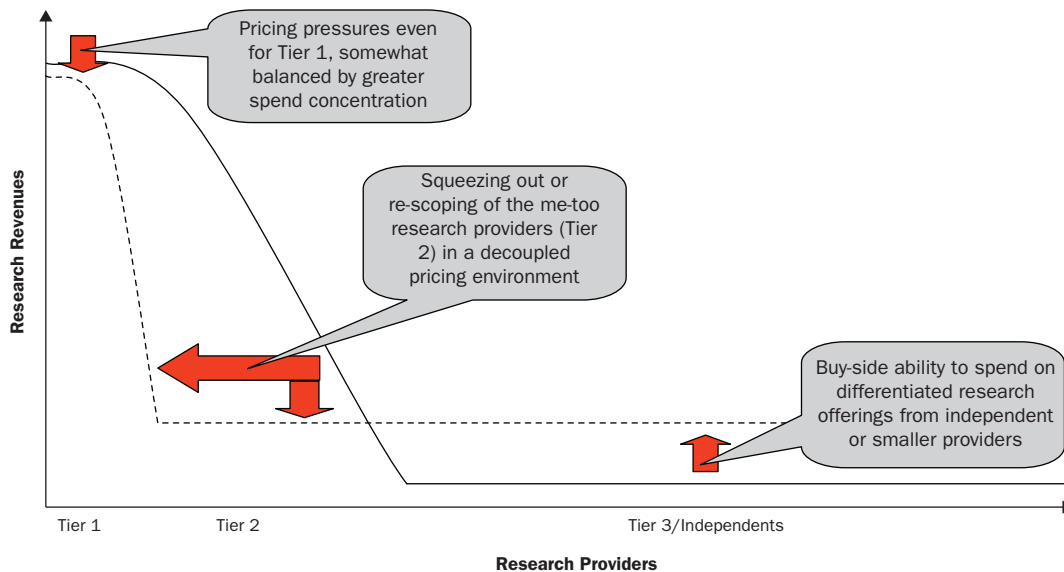
Sell-Side Research Imperatives

Praying for continued bundling was never really an option for the sell side. Even before the United Kingdom’s regulatory changes and Fidelity’s U.S. announcements, decreasing commissions were threatening the existing sell-side research revenue model. In fact, unbundling or greater transparency should be seen as an opportunity to innovate a robust business model for sell-side research.

For the sell side, especially midsize firms, it’s important to build a business case for their continued commitment to research provision. For some, the best option may indeed be to exit like Wells Fargo has.

Exhibit 4

Expected Bar-Belling of the Research Market (Illustrative)



Source: Booz Allen Hamilton

Others will commit to emerging as broad-based high-quality research providers, or becoming niche providers of specialty research—either independent or tied to specific order flow type, such as mid-tier stocks.

There are three additional drivers of success:

1. *Delivery Model Streamlining*: More efficient resource allocation within sell-side research groups will drive headcount reduction, rationalize compensation, and increase outsourcing—leading to better-priced research.
2. *Offering Redesign*: Research can be improved by increasing coverage of mid-caps, small-caps, and international stocks. The sell side can also reengineer the current product or deliver new types of research products, such as expert networks or quality models. Providers can enhance service by delivering detailed performance metrics to the client and proving added value. A distribution philosophy that maintains some client exclusivity will also need to be developed since, to quote an interviewee,

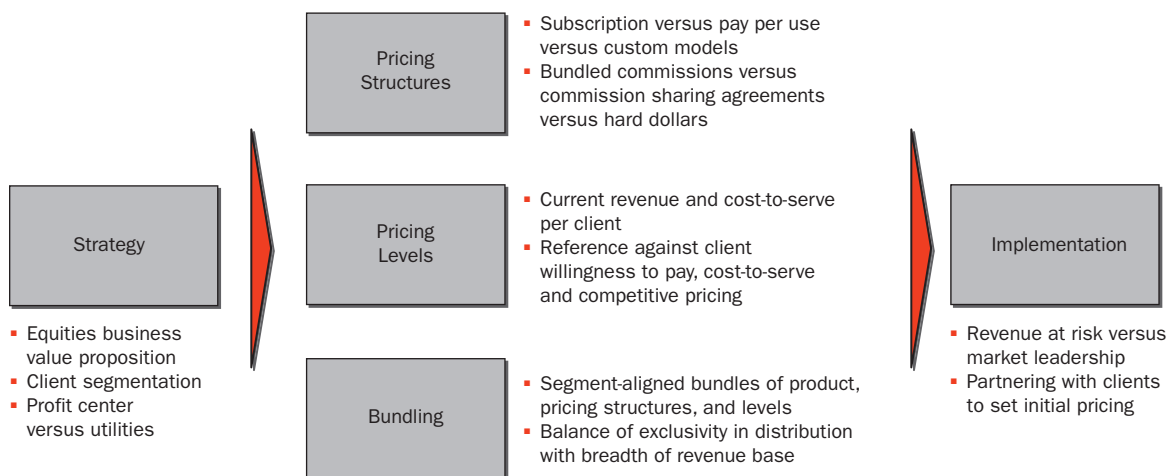
“too many clients kill the value of any single research insight.”

3. *Differentiated Service Levels and Pricing*: Large funds, small to midsize funds, and hedge funds have very different needs, and are each significant sources of research revenues. A modular architecture for research will ensure that sell-side firms can deliver research at different service levels, consistent with client needs. Different pricing models will also need to be developed against client needs; for example, different appetites for unbundling will result in payments for research through bundled commissions, CSAs, or hard dollars (see Exhibit 5).

With ingenuity and willingness to adapt, sell-side firms will be able to weather the current environment’s challenges to their research dominance. A focus on these three drivers of success will allow sell-side firms to deliver the product, service, and distribution formats that the buy-side needs—and will be willing to pay for.

Exhibit 5

Pricing Research



Source: Booz Allen Hamilton

What Booz Allen Brings

management consulting for businesses and governments for more than 90 years. Integrating the full range of consulting capabilities, Booz Allen is the one firm that helps clients solve their toughest problems, working by their side to help them achieve their missions. Booz Allen is committed to delivering results that endure.

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To learn more about the firm, visit the Booz Allen Web site at www.boozallen.com. To learn more about the best ideas in business, visit www.strategy-business.com, the Web site for *strategy+business*, a quarterly journal sponsored by Booz Allen.

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