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Fee-based research takes wing

Supporters of openly paid-for research say it is more trustworthy than reports funded by hidden fees

By Larry MacDonald
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Would you read analyst research on a company if the company paid the analyst?

Fee-based research companies certainly think so, and say their services are growing increasingly popular. The researchers say their work is, in fact, more trustworthy than others' because they openly disclose payment for their reports – unlike research from banks, where other departments such as investment banking, pay for reports on coveted clients.

Brian Tang walked away from his job at a bank in 2003 to launch Fundamental Research Corp. (FRC), a research boutique that produces investment reports on publicly traded companies for a fee. Mr. Tang, a chartered financial analyst, says that when he was working on corporate finance deals at the bank, he noticed that "all equity research is paid for, in one way or another."

So when U.S. regulators uncovered evidence in 2003 that brokerage analysts had their compensation tied to investment-banking deals and recommended stocks they privately disparaged, Mr. Tang saw an opportunity.

The decision to start Vancouver-based FRC was reinforced by the research reports Mr. Tang was reading from bond-rating agencies. They were financed by fees collected from the companies whose bonds were being rated.

Bob Weir is chief executive officer of Canada's other leading provider of fee-based research, Toronto-based Independent Equity Research Corp., better known as eResearch. He is familiar with the bond model, too: he used to be an executive vice-president at Dominion Bond Rating Service Ltd.

Providers of fee-based research in the U.S. and Canada say they minimize conflicts of interest by following practices such as accepting only cash payment in advance, specifying in contracts that the research firm will have full editorial control over the reports, prohibiting staff from trading in a client's shares, and having no side businesses with the client.

The U.S. regulators required dealers to set aside some money to fund independent research and to limit dubious practices, such as giving analysts bonuses to boost investment-banking fees. Dealers can still distribute free research reports to clients, and the cost of production is covered by fees from investment-banking and trading operations.

Investment dealers tend to concentrate research coverage on companies with large market capitalizations because that is where the investment-banking fees and trading commissions come from. About 60 per cent of the companies listed on the stock market are not covered by analysts, according to Vikas Ranjan from the fee-based research firm Ubika Research Inc. in Toronto.

Ubika, in its first year of operation, has completed reports on 10 companies, with analysis on another five companies coming in the next month or so. Since inception in 2000, eResearch has written reports on more than 350 companies. FRC currently covers about 100 companies and was recently ranked 20th on Business in Vancouver's list of the top 100 fastest-growing companies in British Columbia. Other boutiques, such as Howlett Research Corp., have written up reports on dozens of other companies.

"Academic studies in markets around the world have demonstrated, time and again, that equity research tends to have a positive impact on liquidity," says Ubika's Mr. Ranjan. The companies covered tend to have higher valuations and a lower cost of capital, while investors have more access to data and information.

Most clients come from the junior ranks of the mining and energy sectors. For example, oil and gas explorer Petromin Resources Ltd. recently paid FRC about $30,000 to begin coverage, with a 28-page report published on April 15.

"The first day that we released the report, our stock price closed with a 26 per cent increase and four times the volume," said Petromin Resources vice president of corporate affairs, Mike Suk. The company is listed on the TSX Venture exchange.

Suppliers of fee-based research differentiate themselves in various ways. Ubika Research says it raises clients' profiles by sending research reports to a network of investment advisers and security lawyers. The firm also publishes smaller, one-time reports for micro-cap companies and has linked up with Canadian Quotation and Trading System Inc. to provide profiles on "emerging companies."

FRC's research is tracked by investars.com, an independent investment research website. Prior to the commodity downturn, investars.com ranked FRC among the top 10 investment research firms in North America.

FRC employs six full-time, in-house analysts and does not outsource its research to off-site analysts "to write the report on the weekend or evening," Mr. Tang says. Most analysts hold MBAs, are completing or have finished the Chartered Financial Analyst course, and are bound by the CFA Institute's code of ethics.

Fees charged to companies typically range from $15,000 to $30,000 per year for a 15- to 40-page report, with updates at specified intervals. The research is distributed widely through a variety of channels, including the boutiques' own websites, third-party broker-dealers, and websites such as Thomson First Call, Reuters Estimates, Baystreet.ca, Stockhouse.ca, and Zacks Investment Research.

Critics say fee-based research houses have an incentive to get repeat business by issuing glowing reports. But the firms say that if readers regularly got burned by their research, it would undermine the analysts' credibility and cost them business.

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