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BY JON MERRIMAN AND WILLIAM J. FEBBO

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THE BUY SIDE WANTS DEEPER AND MORE DIFFERENTIATED RESEARCH.
WHO'S ANSWERING THE CALL?

WITH INCREASING COMPETITION AMONG BUY-SIDE firms for solid analytics and the staggering growth of hedge funds over the past several years, the demand for differentiated research has never been stronger.

Yet the number of sell-side analysts has dropped from more than 16,000 in 2001 to just over 9,000 in 2006, according to a Tabb Group report. And Booz Allen Hamilton Inc. last year cited experts predicting sell-side revenue to fall a further 50% over the next few years.

What gives?

Over the past several years, professional money managers have evolved in terms of what kinds of research they want. This change in appetite on the buy side has created several repercussions. Sell-side research houses are being forced to adapt or die. Primary research is emerging as a strong complement to sell side. And the buy side is becoming increasingly sophisticated, building its own in-house research teams and demanding more of its third-party providers. This evolution, painful for some, is having a profound positive impact on the markets, as investors go deeper and get smarter about the companies in which they're investing.

On the sell side, the "adapt or die" mandate is playing out in two key ways: the type of analyst firms are hiring and the companies those analysts are covering.

Today's analysts—who are no longer driven by deal revenue—are in the game because they love getting their hands dirty, tearing apart balance sheets, asking difficult questions of a company's management team and obsessively tracking their sector.

This generation of sell-side analysts is also more interested in finding unique plays—not just following the herd and chasing name-brand stocks—and going deeper in their analysis, which ultimately benefits both the firms they cover (which get the legitimizing influence of analyst coverage) as well as investors (who get expert analysis of unique stocks). Such analysts have always been around but had previously been the exception rather than the norm.

The emergence of new roles and business models for the sell side is also interesting. In some shops, sell-side analysts are serving as business advisers to their buy-side counterparts to help them develop research teams and strategies. This consulting role feels counterintuitive, but for some firms it makes sense as a way to capitalize on a trend

that is going to happen whether they become involved or not. Even offshoring has found its way into the research game, with firms sending some of their nonanalytical work (e.g., compiling market data, testing models) out of the country. These fundamental changes in how the sell side defines itself are reflective of the need for these firms to rethink what has always been, to put it mildly, a curious business model.

The buy side also looks much different now than it did a few years back. Most notably, hedge funds have changed the landscape. Global gross assets under management in hedge funds, as estimated by the Center for International Securities and Derivatives Markets, has exploded from around \$30 billion in 1990 to a little more than \$400 billion in 2000 to more than \$1.2 trillion in 2005.

With higher management fees—and higher expectations from investors—hedge funds always seek a competitive edge. For many, this means building out research teams of analysts and industry experts.

For others, alternative research models are the preferred approach. The emergence of primary research has allowed buy-side analysts to find unique expert analysis about products, companies and burgeon-

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ing sectors such as clean technology. As the name suggests, primary research gives investors direct access to experts who can provide both a broad range and a depth of perspective. For instance, a portfolio manager looking for information on an up-and-coming pharmaceuticals company would benefit from the knowledge of, say, physicians, researchers, regulators and financial analysts.

Such additional services reflect changes happening in research as the buy side seeks better, faster and deeper analysis and the sell side strives to answer the call by improving old models and building new ones.

Like most change, this is bad news for those who are locked into the status quo, but it's great news for the industry and its innovators. ■

Jon Merriman is CEO of investment bank Merriman Curhan Ford & Co. William J. Febbo is CEO of Panel Intelligence LLC, a primary research provider.



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