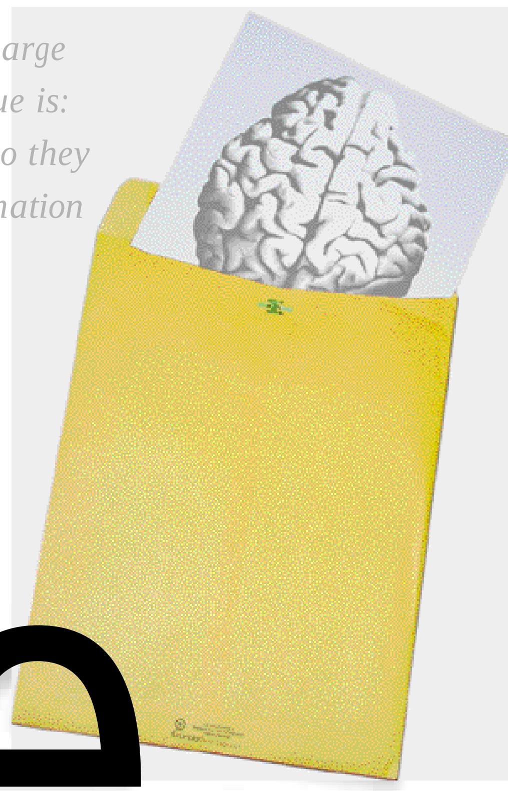
By Joe **Hassett** and Bill **Mahoney**

Small companies unable to attract coverage from the big wirehouses and regional brokers are turning to another source — specialty firms paid a fee to write and distribute "research" reports. The easy access to this information on the Internet is helping these providers claim large on-line investor audiences. But the real issue is: How useful is this research to investors? Do they even read it? And, do they act on the information and recommendations?



Research for Sale

Can’t get any research coverage from the brokers? Don’t despair. You can always buy it.

Encouraged by the bull market and the frustrations of CFOs at small companies at not being able to garner any following by the sell-side brokerages, so-called independent firms have sprouted up, offering research for a price. Judging from the flow of fee-based research reports flooding cyberspace and filling fax machines, the practice has taken off big-time.

Maybe to the surprise of some, the sliding economy and stock market don’t appear to be putting any brakes on the momentum. In fact, the opposite is occurring. Desires by micro, small, and even mid-size companies to get more exposure in the face of a down market seem only to be feeding the paid research frenzy.

The question for company executives is, How valuable is this coverage? In fact, there are lots of questions. Are investors paying any attention to it? After all, the argument goes, since companies are paying for it, it must be positively slanted. Is it aimed strictly at individuals, or are the institutional pros looking at any of it? Indeed, is it even legal?

And then there’s perhaps the most practical question: Accepting the notion that there is a legitimate role for fee-based research, which providers are really adding value to the investment process and which ones are hype artists who are probably doing their company clients more harm than good? The bottom line for CFOs and IROs buying this research:Buyer beware!

Serving Ignored Companies

A sound premise supports the explosion of paid research: Thousands of companies are being overlooked in the battle for investor attention. Facts prove the contention. Richard J. Wayman, a chartered financial analyst (CFA®) and founder of researchstock.com, cites research from Thomson Financial/Baseline showing that 1,558 of 4,890 companies with market caps under $500 million have no analyst coverage. Further, those remaining 3,332 companies have fewer than two analysts, on average, covering them. Read one, probably the investment banker.

Contrast those numbers with the 25 analysts, on average, following companies with market caps of over $200 billion, says Wayman.

Wall Street easily rationalizes its focus on the big stocks. That’s where most of the investment money is going. Large institutions provide the bulk of stock transaction commissions, and they need liquidity to buy and sell sizable positions without moving share prices. With volatility at all-time highs, these money managers are willing to pay a premium for liquidity.

That’s just one reason. Razor-thin trading spreads, caused by competition and regulation, exacerbate the need for brokers to have liquidity to ensure some profit margin on high-volume transactions.

Then, there’s the competition for investment banking deals. It has led to accusations of tainted research, namely positive coverage to help banks curry favor with corporate CFOs and CEOs. “With every investment banker vying for the same deal, research coverage has become a lemmings market with everybody following the same stocks,” says Wayman.

Still one more factor is the merging of regional brokerages into the major houses, significantly reducing opportunities for small local companies to raise capital and gain coverage. In raising money, companies often worked their way up the chain of small and regional investment houses that provided support from infancy through development.

Purveyors of paid research argue that all research costs companies money, in one way or another. Small companies aren’t likely to be followed without an indication of investment banking business. “Our program gets the company coverage without having to offer an investment banking deal,” argues Sherry Grisewood, CFA, who does research for The Public Analysis and Research (PAR) program of Investrend Research, one of the many firms offering research for a price.

Serious conflicts of interest exist at Wall Street firms, say fee-based proponents in claiming their research can be just as objective. “At least we’re not trading in the stock,” claims Karen Snedeker, managing director of BlueFire Partners in Minneapolis, an investor relations firm that also has registered to be an investment advisor. BlueFire requires companies to be an IR client before research is written. But not all clients qualify, says Snedeker. “Basically, it is a service for those that deserve research and do enough with us to warrant it.”

Wayman, who collects fees for research at researchstock.com, questions the objectivity of Wall Street analysts. Their compensation packages, he argues, include a base salary, percentage of banking deals, and trading volume

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— Sherry Grisewood, of The Public Analysis and Research (PAR) program

from aftermarket transactions. With fee-based providers, "the compensation is fixed and not dependent upon investment banking deals or stock trades," says Wayman.

Getting to Know Them

Who are these folks and what are their credentials? Clearly, they are opportunists, filling a void as they see it. Many come from Wall Street and the buy side. Investor and public relations people also have stepped into the breach. Being an analyst, with CFA stature, helps establish a level of experience plus market/investing knowledge, but it doesn't guarantee legitimacy.

The "research" takes a number of forms, which serve to differentiate providers' qualifications. Basic is the investment profile, essentially offering just information about companies. These are disseminated as company-specific reports, typically faxed to a distribution list or put on the provider's Web site for access by subscribers. On-line newsletters also are popular, frequently covering more than one company in an issue.

At the next level are research reports akin to Wall Street products. A professional report, says Wayman, delivers "a balanced view by discussing a company's competitive advantages, provides an overview of the firm's prospects/challenges facing the company and industry, analyzes operating results against a relevant peer group, and provides earnings estimates based upon assumptions that are clearly stated."

Legitimate research includes a solid discussion of the risk factors. In addition to earnings and probably revenue forecasts, most of these reports also include buy/hold recommendations and target stock prices.

At the lowest level are pure hype reports. Unfortunately, these abound in cyberspace, and some are unbelievably bold. Some recent samples make the point. "THIS IS A STOCK TO PURCHASE!" "Thaon Communications is a very strong buy, with a target of $6! We think this is a stock you should own right now." Or, in reference to another company: "By far the best stock we have ever covered."

Wayman suggests checking the language for clues into unadulterated hype. He admonishes companies and investors to be cautious of reports full of promotional language while "sparse on details" or using phrases like "the stock will rocket to new highs" or the author "guarantees" a sizable return.

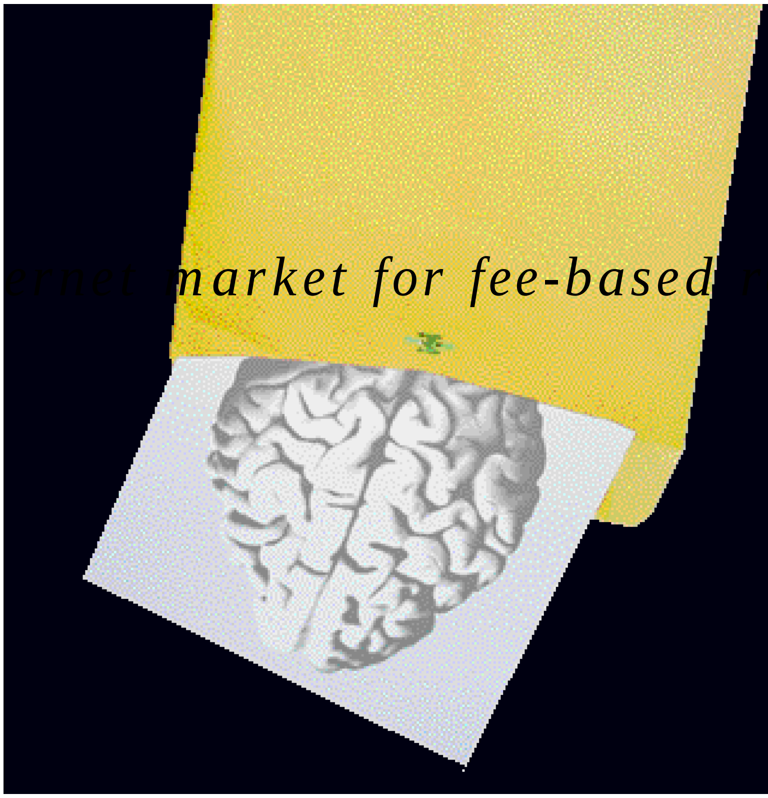
Key Factors in Picking a Provider

Quality of research, length of time coverage is provided, costs, and audience impact are vital factors in deciding if a fee-based approach to gain market coverage is a value-creating proposition for a company. Costs can vary widely; we have seen fees from $7,500 to $50,000. And some providers take stock, which should raise a red flag on the issue of objectivity.

The time frame for giving coverage is a factor. A one-time report should be viewed with suspicion. Investors aren't likely to give it much weight; hype is written all over a report that isn't part of an analyst's commitment to follow the company. By comparison, Wall Street analysts add value by covering a company over time. A year-long contract at least ensures some follow-up reports.

Audiences also matter — in terms of size and quality. The Internet market for fee-based research essentially is individual investors. Some Web site providers claim an institutional following. Quantity and quality of audience don't necessarily go together. Paid subscriber and opt-in

The Internet market for fee-based research



e-mail audiences are likely to be more serious, upscale investors, compared with purchased audience lists.

Investors and companies are wise to assess the quality of the research on a provider-by-provider basis, covering both the information-only and forecast/recommendation groups.

Key considerations focus on the experience and qualifications of the research analysts. Does the provider truly have a corps of credentialed research analysts? Is the resource essentially an investor relations or public relations firm? Bottom line:Know what you are buying.

Some of the Players

Knowledge is in the details, and in how various providers look at their own service. Skip Nordstrom operates the *GrowthStock Newsletter* (www.NICStock.com), published by the National Investors Council. He writes a 4-page, glossy, one-time information report for $7,500 per report, plus expenses for a site visit to interview management.Longer-term contracts are encouraged.Client leads typically come from PR and IR firms, and market makers. A proprietary audience database consists of about 3,000 opt-in investors.

PAR (www.investrend.com) has a team of analysts, mostly CFAs, says Grisewood, and the firm doesn't hold stock in companies it writes about. Fees are $19,700 a year for an initial report, quarterly updates, and any further reports warranted by events. Companies typically are in the $50–$60 million market cap range, but can go as high as $200 million. A 75,000 e-mail audience can expand to a million viewers via several participating Web sites, adds Grisewood.

Alan Stone (www.WallStreetResearch.org) includes recommendations and stacks his research team against the Wall Street firms. He says his background includes stints at Merrill Lynch as an analyst and as a portfolio manager. Because the firm covers microcap companies, fellow analyst Richard Goldman says that time boundaries need to be put on their recommendations. "Things can change so fast, reports are only good for a definitive period of time," according to Goldman.

OTC Growth Stock Watch is a small cap newsletter, profiling companies for an audience of about 300,000 subscribers who opt-in to the site. Companies qualify for inclusion based on certain criteria and don't pay a fee to be featured. OTC Financial Research, the parent company, also produces "glorified fact sheets" for a fee and conducts IR programs, says Geoff Eiten, president. The firm claims to not make recommendations in its fact sheets, despite a statement in one such profile reading, "We consider the stock to be undervalued."

Steve Reid, editor of the Moebius Free Financial Newsletter, says that services like his are "no different from a brokerage firm's. The brokers won't help you unless you're a corporate finance client." Reid specializes in e-mail distribution and claims to have access to 200 million names on a global scale. His research is mainly information-based, poured into the market on a fee structure with discounts based on size of order. Costs to saturate the market can run over $1 million. Reid also creates streaming videos for online distribution. Most of his clients are trying to raise money, he says. "Much of what we do is create liquidity."

SmallCapReview (www.smallcapreview.com) claims to *essentially is individual investors.*

have a large institutional following, with subscribers opting in. "We don't buy mailing lists or swap names," says Thomas Englebert, editor. He says that the Web site focuses on small companies with good growth prospects. "We want to build subscriber loyalty and trust." Englebert won't reveal his site's number of subscribers. "We consider that proprietary, but we are very pleased with our growth rate," he says.

After serving seven years as an equity analyst, Rick Wayman founded researchstock.com in 1999 as an independent, fee-based research firm based in Columbus, OH. He sees fee-based research as a "useful way to bridge the gap between companies with investment potential and investors looking for new ideas and undervalued stocks."

The Legality of the Matter

Is all this cyberspace traffic legal? The distinction comes in whether the provider is a broker dealer or investment adviser and thus subject to the Investment Advisers Act of 1940, or whether it is a publisher. According to the Act, investment advisers provide advice, make recommendations, issue reports, or furnish analysis on securities, either directly or through publications. As such, they must register with the Securities and Exchange Commission. They can get into trouble by providing materially false or misleading statements about public companies.

Producers of general and regular circulation publications are excluded from the definition of investment adviser as long as they don't offer individualized advice tailored to the investment needs of specific clients. The SEC has gotten publishers to agree to consent decrees and pay penalties. Brian S. Hamburger, an attorney for the law firm of Stark & Stark, suggests that criteria for judging the legality of newsletter or Web site content seem to be determined by the SEC on a case-by-case basis.

Can't Quantify the Value

Our research fell short in finding companies or portfolio managers buoyant about the value of fee-based research. Understandably, companies ponying up the funds aren't anxious to talk about their experiences. Robert Benou, president of Conolog, followed the advice of Geoff Eiten to put out a lot of news. Benou believes it helped in keeping the price from taking a "nosedive" when the market fell in the spring of 2000, and to pick up when some recovery occurred.

Richard Twardowski, IR director at IVG Corp., can't say that the heavy communications urged by Moebius editor Steve Reid has impacted stock price, but he says that it did serve to boost trading volume. And Richard Pierce, CEO at Laredo, said its source, Revealer, "generated a fair number of calls, but it's hard to say what influence it has had on stock price."

On the investment side, Ken Sevinsky, Jr., senior portfolio manager at Fifth Third Bancorp in Cincinnati, sees a place for paid research among small cap companies. But he also has his doubts. "I wonder how you draw the line of being objective while the company you are covering is paying you," comments Sevinsky.

Objectivity? Chuck Hill, director of research for Thomson Financial/First Call, issues a warning to investors about fee research. "If there is no analyst's name on the research, then buyer beware," says Hill. About the opportunity for companies to make the investment screens of institutions requiring at least one analyst earnings forecast, Hill has bad news. "We clearly would not use somebody that does research and was paid for it," he says.

A final word comes from Robert J. Flaherty, longtime editor of *Equities* magazine, which specializes in understanding small companies. Improved liquidity may be the chief benefit of paid-for research, suggests Flaherty. Plus, it's better than no research, he adds, as long as it's honest. What he doesn't like is stuff like "'This is the next General Motors.' They're trying to have the company take on the attributes of the giants."

Flaherty says that companies and investors should want information in these reports about management and about risk. "There's a lack of management background in these pieces." Risk needs to be disclosed, especially about competition, adequacy of financing, and other basic financial considerations, he adds. "And, any projections should be reasonable." SV

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