

A BRAVE CALL

IS IT TIME FOR INVESTMENT BANKS TO EXPLORE
ALTERNATIVE RESEARCH MODELS POST-MIFID II?



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EXECUTIVE SUMMARY

With just over six months until MiFID II goes live, the global investment research industry is on the cusp of major disruption. While a plethora of issues confront both the buy- and sell-sides in the lead up to the implementation in January 2018, pricing appears to remain the key area of contention for the industry, given the substantial misalignment between broker and manager expectations.

While many managers still have much to do to meet their obligations under the new regulatory regime, we believe it is the sell-side that is facing the biggest competitive disruption, with downside risks greatest for the global investment banks. Burdened by inherent conflicts between their research and investment banking departments, as well as stubbornly high costs due to complicated cost structures, managers are increasingly looking for alternative content providers in their quest for high-quality, cost-effective research.

Independent research providers (IRPs), in particular, have been steadily gaining traction in the lead-up to MiFID II. Much of this reflects their capacity to produce high-quality, independent analyses at a considerably lower cost than major sell-side players. Recently, we have seen a host of new IRPs emerge, with analysts from bulge bracket firms capitalising on low barriers to entry to set up their own firms. Industry consolidation is also on the rise as incumbent IRPs look to consolidate their competitive edge and capture economies of scale.

From a provider perspective, many analysts we spoke to cited improved work-life balance and greater intellectual freedom as benefits of working at IRPs, including significantly less focus on producing maintenance research. Some IRPs also adopt revenue share compensation arrangements that are closely tied to individual performance.

From a consumer perspective, beyond providing highly specialised content, IRPs have relatively flexible payment models (from annual subscription fees to one-off charges for bespoke reports). Smaller managers are also able to afford investment research, as pricing schedules of IRPs are considerably cheaper. Most importantly, the ability to provide unconflicted, independent analyses sets many IRPs apart from the investment banks, where conflicts still pervade.

The continued migration of research spend from incumbents to IRPs, coupled with the high costs associated with sustaining research divisions, is putting increasing pressure on the P&Ls of large investment banks. We believe some investment banking research departments are facing potential losses of up to USD 240 million by 2020 under their current structures.

To evade these pressures, brokers can opt to transition from the current “fully-integrated” model to alternative research models – namely, operating research out of a separately-owned entity, such as a joint venture (JV), or outsourcing research to IRPs (either directly or via online research marketplaces (ORMs)), such as Société Générale’s (SocGen’s) partnership with Smartkarma.

With the MiFID II regulatory go-live around the corner and a largely negative outlook for major sell-side players on the horizon, we believe some brokers will need to make a brave call around their future business models.

SECTION 1

THE SELL-SIDE RESEARCH DILEMMA

As we have highlighted in our previous reports, MiFID II's unbundling provisions are likely to cause considerable disruption to the global investment research industry, particularly with respect to competitive dynamics on the sell-side. We think the largest global waterfront brokers are facing the greatest downside risks.

In this section of the report we identify three key challenges full-service integrated sell-side brokers will face in a post-MiFID II world:

1. Ongoing conflicts of interest between a full-service investment bank's investment research and investment banking business;
2. High costs of research teams; and
3. Structural changes in the operating environment, including the impact of MiFID II, CSA allocations for best execution, and the expectation that more independent analysts will enter the fray.

1. CONFLICTS OF INTEREST

The bursting of the dot-com bubble in the early 2000s exposed problems associated with the provision of investment research by integrated investment banks – namely, the conflicts that faced many investment banking research analysts, who were encouraged to write favourable coverage of particular issuers or securities to support the banks' primary deal-making businesses and generate orders through their execution desk.

In the aftermath of the dot-com collapse, a number of new regulations relating to investment research were implemented by the Financial Industry Regulatory Authority (FINRA). New provisions that focused on research analyst conflicts of interest were also incorporated into the Sarbanes-Oxley Act. Specific regulatory changes included:

1. De-linking compensation for research and investment banking departments;
2. Prohibiting investment banking departments from having an input into research analysts' compensation;
3. Creating a new investment review committee responsible for approving all research recommendations; and
4. Disclosing any compensation received from a covered company over the preceding 12 months.

Despite the regulatory changes, we have still witnessed a number of cases in recent years where conflicts of interest have arisen between a bank's primary and secondary businesses. One of the more notable incidents occurred in December 2014, when FINRA slapped 10 major banks with a total fine of USD 43.5 million for offering favourable stock research in the hope of securing an underwriting role in the IPO of Toys 'R' Us Inc.¹

¹ FINRA, 'FINRA Fines 10 Firms a Total of \$43.5 Million for Allowing Equity Research Analysts to Solicit Investment Banking Business and for Offering Favorable Research Coverage in Connection With Toys 'R' Us IPO,' 11 December 2014, available at: <http://www.finra.org/newsroom/2014/finra-fines-10-firms-total-435-million>

Perceived conflicts can also extend beyond the coverage of corporations, especially where there are undue expectations from other parties. In August 2015, JP Morgan lowered its rating on Indonesian government bonds from “overweight” to “underweight.” As a result, the Indonesian central bank governor accused JP Morgan of ‘spreading panic’ and the then-finance minister said the bank would be ‘sanctioned’.² After JP Morgan released a report downgrading Indonesia’s equity rating to “underweight” in November 2016, officials said the Ministry of Finance stopped using JP Morgan as a primary dealer and underwriter for sovereign bonds.³ Subsequently, in January 2017, the Indonesian government said it had severed all ties between the finance ministry and JP Morgan, due to the equities rating downgrade.⁴

A recent consultation paper released by the UK’s Financial Conduct Authority (FCA)⁵ on the availability of information in the UK equity IPO process explicitly highlights the potential bias associated with connected research produced by analysts within investment banks that are part of the IPO’s book-running syndicate, including the ‘significant pressure’ placed on analysts to produce favourable research if their bank is to win a role in the book-running syndicate. It also expresses concerns that analysts in non-syndicated banks and independent research providers lack access to the information they need to produce unconnected research on an offering.

The consultation paper acknowledges that ‘[f]eedback from buy-side investors was unanimous in supporting our aim to create the necessary conditions for unconnected research to feature in the IPO process,’ and that the buy-side was willing to pay, and had in the past paid for, unconnected research. As a result, the paper proposes that unconnected analysts also gain access to an issuer’s management before any connected research is released, in order to improve the range of information available to investors at an early enough stage in the IPO process to support ‘more balanced investor education and price discovery.’

Even today, we still find there to be a heavy bias towards the provision of positive ratings by integrated brokerage houses. When examining analyst recommendations across all major investment banks, an average of 43% of stocks covered by tier-1 banks and 48% of stocks covered by tier-2 banks were given a “buy” recommendation, with a mere 12% and 7% tagged with a “sell” recommendation respectively. For tier-1 brokers, this translates to an average buy-to-sell ratio of 3.6:1, with the corresponding figure for tier-2 brokers being 7.2:1. In fact, the lowest buy-to-sell ratio among all global tier-1 players is 2:1 (see Figure 1).

2 Reuters, ‘Indonesia finmin says JPMorgan “sanctioned” for negative research note’, 27 August 2016, available at: <http://www.reuters.com/article/indonesia-jpmorgan-idUSL4N1121HH20150827>

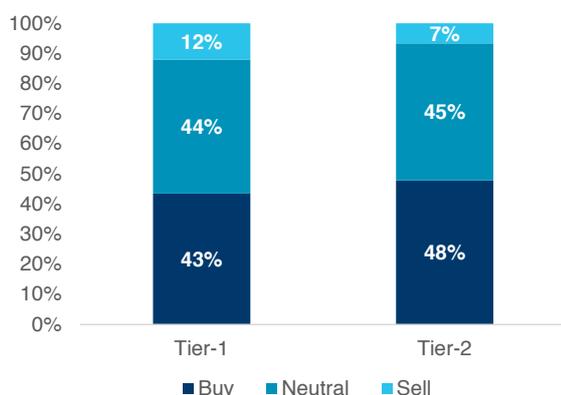
3 Financial Times, ‘JPMorgan in row with Indonesia over equities rating’, 5 January 2017, available at: <https://www.ft.com/content/0d7b302c-d1a2-11e6-b06b-680c49b4b4c0>

4 Wall Street Journal, ‘Indonesia Cuts Ties With J.P. Morgan Over Downgrade’, 3 January 2017, available at: <https://www.wsj.com/articles/indonesia-cuts-ties-with-j-p-morgan-over-downgrade-1483434650>

5 Financial Conduct Authority, Consultation Paper CP17/5**, ‘Reforming the availability of information in the UK equity IPO process,’ March 2017.

FIGURE 1: BROKER STOCK RECOMMENDATIONS

ANALYST STOCK RECOMMENDATIONS
TIER-1 VS. TIER-2 BROKER AVERAGES



RATIO OF BUY-TO-SELL RECOMMENDATIONS
TIER-1 VS. TIER-2 BROKERS

	MIN	AVG	MAX
Tier-1	2.0	3.6	15.5
Tier-2	1.4	7.2	51.0

Note: data as at May 2017

Source: Investar, Quinlan & Associates analysis

Given the greater ability to generate commission income off the back of a “buy” rating (as the potential trade applies to all investors), it is unsurprising these rating biases remain.

2. HIGH COSTS

The costs of investment banking research departments remain stubbornly high.

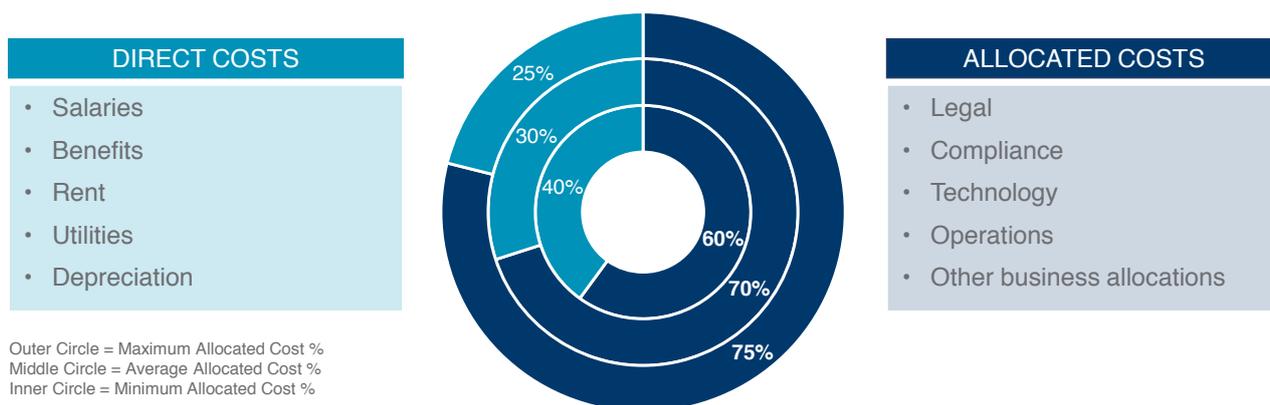
Whilst the compensation of star analysts has been substantially reduced since the heady days of the 2000s dot-com bubble, salaries for equity research analysts still remain relatively high, given research is viewed as a “front office,” revenue-generating function. Our discussions with numerous industry professionals indicate sector heads can command base salaries in excess of USD 300,000, with bonuses of 50-100% of base salary. Our interviews with industry professionals suggest a number of star research analysts are still paid total compensation near USD 1 million p.a., though this is becoming increasingly rare.

Beyond high fixed compensation costs, most research divisions of brokers still operate as quasi-cost centres, where the prerogative is to allocate the costs of the research division to the trading and investment banking business, rather than to generate a return on equity comparable to other businesses. In fact, many research arms receive “subsides” from other departments. Moreover, the separation of research from trading, coupled with the firewalls that exist between research and investment banking, has led to the creation of separate and duplicative overheads, as well as various compliance and control frameworks that are costly to maintain.

More critical than high fixed costs and duplicative overheads between departments, however, is the problem of allocated costs; all business divisions within investment banks are regularly saddled with costs from central group functions, such as compliance, operations, and technology, as well as cost allocations from other “connected” business divisions. Based on our discussions with senior management at a number of tier-1 global firms, allocated costs can represent up to 75% of the total costs of a global bank’s markets business (see Figure 2). Given such constraints, investment banks need to price their research considerably higher than IRPs, whose costs are direct and controllable.

INVESTMENT BANKS NEED TO PRICE THEIR
RESEARCH CONSIDERABLY HIGHER THAN IRPS,
WHOSE COSTS ARE DIRECT AND CONTROLLABLE.

FIGURE 2: DIRECT VS. ALLOCATED COSTS (GLOBAL BANK – EQUITIES BUSINESS)



Source: Quinlan & Associates proprietary data

3. COMPETITIVE ENVIRONMENT

MiFID II is likely to cause considerable disruption to the global competitive landscape for research.

We foresee investment banking research revenues coming under significant pressure as managers become more prudent in their research consumption, and wallet share is increasingly captured by a new wave of cost-effective and high quality IRPs (see Section 2).

In the face of the growing competition from IRPs and greater selectivity around manager spend, there is early evidence that some brokers might be looking to “loss lead” with access to their written work.

This typically involves charging a very low fee for access to their online content in order to compete with IRPs, with the hope of offsetting any revenue shortfall through the sale of premium services (e.g. analyst meetings, conferences). This is especially the case for some of the non-bulge bracket investment banks.

While discounted subscription pricing might be a sensible way to attract a larger user base, we believe efforts to “loss lead” may result in several brokers’ P&Ls being underwater come 3 January 2018, with costs of production significantly exceeding revenues. As a result, an entire research platform could potentially be seen by regulators as an “inducement”, contradicting the very essence of MiFID II’s unbundling regulations.

SECTION 2

RISE OF THE IRPS

INTRODUCTION

Independent research providers (IRPs) have been steadily gaining traction in recent years, underpinned by their capacity to produce high-quality, in-depth independent analyses at a considerably lower cost than major sell-side brokerages. When taking a holistic view of IRPs, we have identified a number of key industry trends.

GROWING COMPETITION

We are seeing a strong correlation between the impending MiFID II reforms and the growth of new entrants in the IRP market.

Many of the new IRPs are headed by prominent analysts, coveted for their high-quality coverage after having built up a substantial investor following during their sell-side careers. For example, in 2016, Mark Pacitti, a former Goldman Sachs researcher and quant at hedge fund Citadel, founded research firm Woozle, and Rod Manalo, a former M&A director at Jefferies, launched the research firm Manalo LLP.

Cutbacks in banks' research functions – such as Nomura in Europe, which announced in April 2016 that it was closing its European equities business – led to a number of senior analysts launch their own research firms. In 2016, Des Supple, Nomura's ex-global head of research, founded Event Horizon, while Jens Nordvig, ex-head of fixed income research, launched Exante Data, a big data firm targeting hedge funds. Phil Rush, Nomura's former UK chief economist, also founded a firm called Heteronomics (see Figure 3).

The trend to set up shop alone has not been limited to Europe. In Asia, a number of senior research analysts have launched their own IRPs. In 2016, Athaporn Arayasantiparb, UOB's ex-head of research in Thailand, set up M Corp Review, specialising in Thailand thematic equity. A few years earlier, PK Basu, ex-global head of Malaysia research at Macquarie Group, established REAL-Economics.com, focusing on Asia macro and thematic research.

A number of analysts have also gone on to produce research independently as "free agents", either alone or via centralised platforms, including ex-CSLA bank analyst Mike Mayo, ex-CLSA China analyst Scott Larprise, and ex-Morgan Stanley Japan auto analyst Noriaki Hirakata.

FIGURE 3: RECENT IRP LAUNCHES (2016-PRESENT)

Year	Analyst	Ex-Employer	Previous Role	New IRP Name	Specialisation
2016	Mark Pacitii	 CITADEL	Head of Global Quantitative Strategy	 Woozle	Primary market research
2016	Rod Manalo	Jefferies	Head of Europe/Asia event-driven strategy	 MANALO	Event-driven research
2016	Des Supple	NOMURA	Head of Global Market research	 EVENT HORIZON RESEARCH	Economics/macro
2016	Jens Nordvig	NOMURA	Head of Fixed Income research	exante data	Big data/macro strategy
2016	Phil Rush	NOMURA	UK Chief Economist	Heteronomics	Economic research
2016	Athaporn Arayasantiparb	 UOB	Head of Thailand Research	M Corp Review	Thai thematic equity
2017	Cristina Marzea	 BARCLAYS	Head of CEEMA & LatAm Banks	Veritum Partners	Banks research
2017	Mike Mayo	 CLSA	Global Banks Analyst	N/A ("Free Agent")	Banks research

Source: Press releases, Quinlan & Associates analysis

We forecast more senior analysts from both bulge bracket and tier-2 firms to go it alone or join buy-side in-house investment firms in coming years, as integrated brokers struggle to monetise their waterfront coverage and budget cuts weigh on analyst compensation.

GREATER WALLET SHARE

The growing influence of independent research houses is being reflected in their financial and market performance, with MiFID II appearing to be a net benefit for leading research franchises.

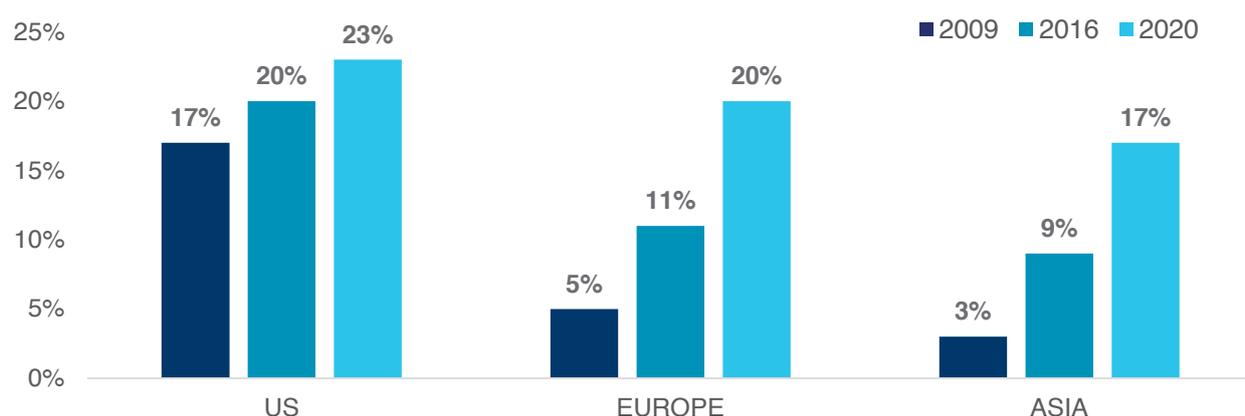
One of the UK's leading IRPs, Redburn, saw its revenues increase by 14.8% y/y from GBP 78.9 million in 2015 to GBP 90.6 million in 2016, according to its most recent financial statements. Moreover, BCA Research, Ned Davis Research, and Institutional Investor – the research arm of Euromoney Plc – reported a combined increase in net revenues of 9% y/y from GBP 150.8 million in 2015 to GBP 164.5 million in 2016. Paul Miskin, CEO of Agency Partners, a privately owned IRP focusing on aerospace and defence, said revenues at his firm have grown 15-20% quarterly for the past six years.⁶

Top-line revenue growth for many IRPs is occurring at a time when research revenues at many global brokers are coming under pressure. As highlighted in our March 2017 report on the rise of online research marketplaces (ORMs), IRPs have already gained considerable market share since the global financial crisis, particularly outside of the US. While we forecast global research spend to fall by 25-30% over the next 3-4 years, we expect IRPs to capture roughly a fifth of the total wallet by 2020, with the most notable gains in Europe (20% market share) and Asia (17% market share) (see Figure 4).

TOP-LINE REVENUE GROWTH FOR MANY IRPS IS OCCURRING AT A TIME WHEN RESEARCH REVENUES AT MANY GLOBAL BROKERS ARE COMING UNDER PRESSURE.

⁶ Financial Times, 'Boutique research groups set to gain from charging shake-up,' 1 March 2017, available at: <https://www.ft.com/content/551ed82a-f1ff-11e6-8758-6876151821a6>

FIGURE 4: MARKET SHARE OF IRPs (2009-20)



Source: Integrity Research Associates, Quinlan & Associates forecasts

INCREASED CONSOLIDATION

As the independent research industry market matures and becomes more substantiated in the lead-up to MiFID II, we are witnessing an uptick in M&A activity as industry players look to establish a more dominant footprint, capture economies of scale, and best position their offering in a rapidly evolving competitive environment where research wallet is on the decline.

In May 2016, private investment firm Fin-Ex announced the acquisition of Roubini Global Economics' (RGE) core subscription business, which would be merged with research firm 4CAST to create 4CAST-RGE. The combined entity has a total client base of 600 financial institutions, and provides a stronger platform for product development to help drive revenue growth. The merger was designed to create a global leader in the provision of independent financial market and macro strategy research.

A few months later in August 2016, Trusted Sources and Lombard Street Research announced they would merge to form TSL Research, in the expectation that buy-side research budgets will increasingly shift to IRPs in the wake of MiFID II. Nicholas Mather, CEO of TSL, said 'Financial regulation is reinforcing two trends whereby asset managers are reducing overall research costs whilst dedicating a greater proportion of total budgets to independent firms. Trusted Sources and Lombard Street Research have capitalised on this new normal and will together offer a global set of independent macro, strategy, country, and sector thematic research services.'⁷

In October 2016, Morningstar, an early investor and 20% equity holder in capital markets research firm PitchBook Data, announced it would acquire the remaining 80% stake in the firm in a deal worth USD 180 million. The move was designed to further combine Morningstar's market intelligence on public companies with PitchBook's coverage of investment and deals for private companies. The acquisition also highlights the considerable premium that IRPs are placing on differentiating their research through the use of proprietary market data (see Figure 5).⁸

7 FTSE Global Markets, 'Lombard Street Research merges with Trusted Sources,' 1 August 2016, available at: <http://www.ftseglobalmarkets.com/news/lombard-street-research-merges-with-trusted-sources.html>

8 PitchBook Press Release, 'Morningstar to Acquire PitchBook Data; Agreement Will Combine Leading Providers of Public and Private Company Research,' 14 October 2016, available at: <https://pitchbook.com/media/press-releases/morningstar-to-acquire-pitchbook-data>

FIGURE 5: KEY M&A TRANSACTIONS BY IRPs (2016)



Source: Press releases, Quinlan & Associates forecasts

As global sell-side players struggle to monetise their waterfront coverage, and adapt to more transparent and competitive pricing, we believe IRPs, where there is a natural fit in content coverage, will accelerate their inorganic growth ambitions in an attempt to strengthen product development efforts and broaden research coverage.

As the competitive environment heats up and global research spend comes under pressure, we are also likely to witness heightened consolidation among more established IRPs looking to capture economies of scale and bring down their operating costs.

SECTION 3

INDEPENDENT RESEARCH: A BETTER MODEL?

THE PROVIDER PERSPECTIVE

In more recent years, we have seen a growing number of top researchers from investment banks emerging at IRPs; both established firms and ones they have set up themselves.

JOINING AN ESTABLISHED IRP

Our interviews with a number of sell-side analysts at global investment banks suggest various push factors are driving top analysts at global banks to join established IRPs, including an ongoing decline in bonus pools, diminished levels of job security, and pressures to cover house stocks positively. Together with the need to frequently push out “maintenance research”, many analysts we interviewed said these were constraining their intellectual freedom and capacity to produce genuine, value-add research.

Moreover, given the ongoing headcount constraints at many global banks, a growing number of senior analysts are facing a rapidly deteriorating work-life balance, with frequent travel, regular late night conference calls, and considerable data crunching becoming increasingly common as junior research associates become a scarce commodity. Many analysts are also spending a considerable amount of their time undertaking menial administrative tasks rather than producing value-add content.

Recognising these challenges, a number of IRPs are attempting to attract top-ranked sell-side analysts by leveraging their capacity to offer more amenable working hours than the major brokerage houses, while simultaneously providing flexibility on compensation. London-based TS Lombard, for example, promotes the ability for its analysts to produce unbiased, independent research that is free of conflict of interests, flexible working hours, and a business model that rewards analysts with a 50:50 revenue share arrangement on their work. The firm hired BNP Paribas economist Ken Wattret in early 2017.

IRPs such as BNP Exane, BNP Paribas’ cash equities joint venture in Europe, have benefited from the buy-side’s growing focus on sourcing high quality, thematic, in-depth research. According to the firm’s London head of research, Ben Spruntulis, the firm is focusing on the type of work many analysts want to be doing. As such, the firm receives at least one new CV every day. In the first half of 2016 alone, the firm’s London office hired five senior researchers from leading investment banks, including Nomura, Citi and UBS.⁹

⁹ efinancialcareers, ‘How MiFID II inspired Exane to build a top equity research team,’ 5 August 2016, available at: <http://news.efinancialcareers.com/hk-en/251878/exane-is-hiring-researchers-this-is-why-you-want-to-work-there/>

SETTING UP AN IRP

Some analysts have chosen to go a step further in their quest for intellectual and work-life independence by setting up their own IRPs.

In addition to some of the firms highlighted in Section 2, one unique Online Research Marketplace (ORM) in Asia, Smartkarma, provides vetted analysts with a platform to develop and sell their own independent content, with a transparent compensation structure that reflects engagement levels with consumers and interaction with other independent providers on the platform. This “online ecosystem” for independent investment insight and analytics has attracted some leading names from the industry, including ex-HSBC consumer analyst Valeria Law, ex-Barclays technology analyst Andrew Lu, and ex-head of strategy at BlackRock, Paul Kitney. The flexibility and uniqueness of its model was recently brought to light when in April of this year, Paul Kitney released his respected “Animal Spirits” report from Mount Everest while preparing for his ascent to the summit.

A number of new IRPs highlighted in Section 2 of this report also contribute their content to Smartkarma, including Rod Manalo (Manalo LLP) and Phil Rush (Heteronomics). We see these online ecosystems representing a powerful new business model in the post-MiFID II world and anticipate that a growing number of sell-side analysts will defect to such platforms in search of improved work-life flexibility, greater intellectual freedom, and a compensation structure that is more closely tied to their individual performance.

THE CONSUMER PERSPECTIVE

PAYMENT MODEL

As outlined in our March report¹⁰, integrated brokers appear to be exploring two revenue models for their research offering; the first being an “all-in” subscription fee for unlimited access to a bank’s waterfront research services (online access plus value-add services), and the second being a “subscription-plus” model that charges clients an annual subscription fee for access to online content and additional fees for bespoke services (e.g. analyst meetings) on an as-needed basis.

From our analysis, we have identified three main revenue models that exist among today’s IRPs (see Figure 6).

¹⁰ Quinlan & Associates, ‘Research.com: the Rise of Online Research Marketplaces,’ March 2017, available at: <http://www.quinlanandassociates.com/insights-research-com/>

FIGURE 6: KEY IRP REVENUE MODELS

	1	2	3
	Subscription	Sponsored	Bespoke
Example			
Description	Periodic payments for access to written research, with limited access to additional services (e.g. analyst meetings/calls)	A defined payment made by a corporate to an IRP to initiate company coverage for a specific quantum of research coverage	A one-off, commissioned fee paid by a client to an IRP to undertake a specific research exercise (e.g. a sector deep-dive)
% IRPs	~95%	~3-4%	~1-2%

Source: Quinlan & Associates analysis

1. Subscription Payment

Under this payment method, buy-side firms are charged an annual fee (usually paid in quarterly instalments) for access to a firm's written research. Typically, an annual subscription will also include limited access to analysts via phone or in person, alongside regular access to sector, industry, or macro policy specific articles, or total coverage of a firm's content via an online proprietary portal (or sent weekly through email).

From our analysis, we found the subscription-based revenue model to be the industry standard for IRPs selling research products, with ~95% of independents charging a subscription fee for access to their research.

2. Sponsored Research

Under this arrangement, a corporation (usually a small-to-mid-cap firm, or an unlisted company) will engage an IRP to initiate coverage of their company. Research on a client company would usually cover its business model and strategy, with financial forecasts, equity valuation, and key sensitivities. A typical offering would include services such as an annual initiation-style report, together with monthly and quarterly reports.

Some firms, such as Edison, are particularly active in the sponsored research space and have built a lucrative business model around covering small-to-mid-cap companies that are often overlooked by larger brokerage houses. We estimate less than 3-4% of IRPs adopt this revenue model.

3. Bespoke Reports

Some IRPs charge clients a one-off fee for a piece of specific commissioned research. These fees can be charged in addition to annual subscription fees, where the scope of research may be outside what is included in a typical subscription – for example, the client may wish to commission a deep-dive and/or report on the outlook for a specific industry, theme and/or country. A number of these IRPs also conduct pre-IPO investigative due diligence and broader market-based survey studies. Firms such as Blackpeak Group are particularly active in this space.

From speaking to industry insiders, we found this revenue model to be more niche, given demand was lumpy and focused more on technical research specialists where insights were needed on a more periodic basis (i.e. per transaction). We estimate only 1-2% of the IRP wallet is generated from the provision of bespoke reports.

PRICING

Based on our research with a number of industry professionals, we found a wide-range of prices being charged by the IRPs.

At the low end of the spectrum, we found annual subscription fees to start at USD 20,000-25,000 p.a. (usually for smaller providers), rising to USD 250,000 p.a. from some of the more prominent industry players. Average fees were generally in the range of USD 40,000-60,000 p.a., with some IRPs, such as Capital Economics and 4CAST, offering a free trial period for investors.

On average, fees being charged by IRPs were considerably lower than those charged by global banks, where we have seen quotes for waterfront coverage ranging from as low as USD 60,000 for pure-play regional players, to between USD 500,000-5,000,000 for global tier-1 firms for access to their research platforms (see Figure 7). However, given the ongoing pushback from the buy-side, we are starting to hear of some global banks exploring 5-digit pricing schedules for access to their online research content, though these specifically exclude any other value-add services such as analyst calls or meetings.

FIGURE 7: ANNUAL SUBSCRIPTION FEES

	MIN	AVG	MAX
IRP	USD 20,000	USD 40,000-60,000	USD 250,000+
REGIONAL	USD 60,000	USD 150,000-250,000	USD 350,000+
GLOBAL	USD 300,000	USD 500,000-1,500,000	USD 5,000,000+

Source: Quinlan & Associates analysis

We found many of the IRPs segmented their fees across their various product offerings, broken down by sector, country, and/or toolkits. This is considerably more granular than pricing schedules being offered by many of the global brokers.

For bespoke reports, we found that pricing would generally start at ~USD 2,500 for a high-level economic newsletter, rising to USD 15,000-20,000 for a more in-depth piece of research. Investigative research firms typically charge anywhere between USD 20,000-30,000 for a 3-4 week research engagement.

OFFERING

While some IRPs, such as BCA and Morningstar, offer comprehensive research coverage across multiple products, sectors, and geographies (akin to the global brokerages), the vast majority of players are relatively niche in their focus, offering in-depth, specialised coverage. As such, IRPs can be selected for their specific content strengths, as opposed to sell-side brokers with mixed capabilities across their waterfront offering.

For example, a number of firms have carved out a competitive niche in the macro and investment strategy space, such as TS Lombard and Capital Economics. Others have established a foothold in credit research, including Credit Sights and Independent Credit View AG. Among the equity research houses, firms such as Redburn and Alpha Value have earned a reputation as credible generalists, while other equity-focused IRPs remain sector focused, including New Street Research (telecoms, healthcare, and internet), Arete (technology, telecoms, and alternative energy) and Drewry (maritime) (see Figure 8). A number of alternative data providers, such as Prattle, are also starting to make their mark in the investment management industry through tools such as machine learning.

FIGURE 8: RESEARCH COVERAGE



Source: Quinlan & Associates analysis

INDEPENDENCE

One of the main reasons put forward by the buy-side for sourcing research from IRPs is that it is free of the conflicts of interest faced by research analysts working at full-service investment banks; namely, that research calls are not being used to drive trading commissions or support a bank’s primary deal flow.

As highlighted in Section 1 of this report, there appears to be considerable bias in the stock recommendations given by research analysts at many integrated investment banks, with “buy” calls significantly outweighing “sell” calls. For many IRPs, buy-to-sell ratios appear to be considerably more balanced – for example, boutique research houses Alpha Search and Boeing & Scattergood currently have buy-to-sell ratios of 0.99 and 0.60 respectively.

Larger research houses, including Thomson Reuters/Verus and Morningstar, also maintain buy-to-sell ratios of less than 1. Moreover, while its analysts don't provide explicit buy or sell recommendations, Smartkarma's overall bull-to-bear ratio has been ~60:40 since inception.

Despite these examples, we have identified a number of IRPs with buy-to-sell ratios considerably higher than the investment banks'. Aegis Capital Corp, Barrington Research Associates, and Benchmark Capital, for example, all have buy-to-sell ratios in excess of 100, and Ameriprise Financial doesn't have a single "sell" rating on any of the 133 stocks it covers.

The question of bias remains particularly unclear for IRPs who engage in sponsored research coverage; as fees are being paid by the company being covered (and not the investors in that company), we believe the removal of bias – and hence achieving true independence – is extremely difficult to obtain. However, for IRPs who derive their revenues from manager subscriptions, we believe they have a stronger motivation than integrated brokers to keep their recommendations impartial, given their sole source of revenue is so heavily dependent on their reputation and the integrity of their insight.

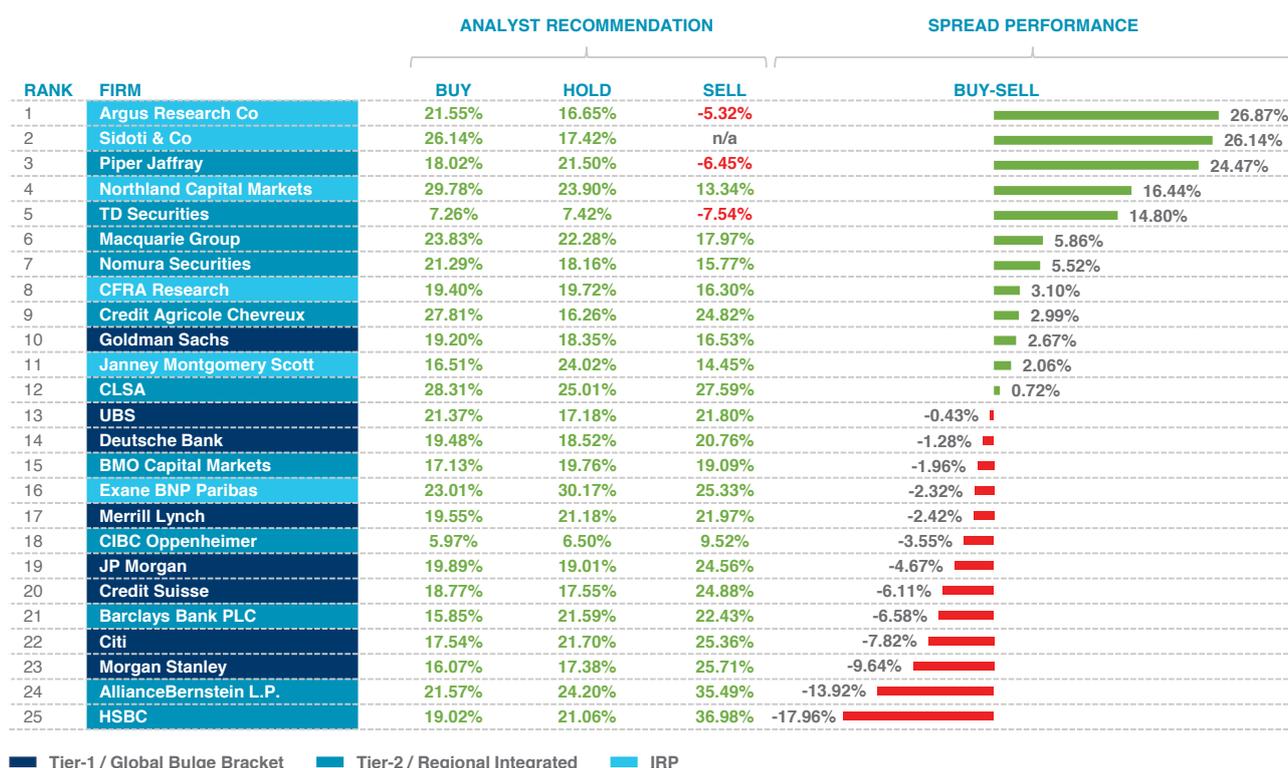
QUALITY

Given a more specialised offering and fewer conflicts of interest, is research provided by IRPs "better" than research sourced from integrated brokers?

One potential way to examine the quality of a firm's research is to look at the accuracy of stock recommendations made by its analysts. When looking at data from Investars on the top 25 most "accurate" research houses over the past 12 months,¹¹ three of the top five research houses were IRPs, with Argus Research Co and Sidoti & Co taking the top two spots. Moreover, among the top 10 most accurate firms, four were IRPs, five were tier-2 integrated brokers, while only one (Goldman Sachs) was a bulge bracket investment bank (see Figure 9).

11 Based on 1-year trailing performance of "buy" calls minus 1-year trailing performance of "sell" calls

FIGURE 9: PERFORMANCE OF STOCK CALLS (1-YEAR TRAILING)



Note: Data as at 7 May 2017

Source: Investars, Quinlan & Associates forecasts

The accuracy of stock calls is, of course, only one way to evaluate the strength of a research provider, given alpha generation is just one of the many “inputs” provided by a research analyst to an asset manager.

The ability to provide access to corporates, identify emerging trends, or provide in-depth insights about a particular industry, are also integral to the role of an analyst.

Sanford C. Bernstein & Co (Bernstein), for example, has built its reputation in the industry around its monthly research *Blackbooks*, which provide unbiased, in-depth company and industry analysis and forecasts with a contrarian flair. Unlike its peers, Bernstein recruits its senior analysts directly from industry, providing it with a unique competitive edge in the industries that it covers. Managers we spoke to value the deep level of insight provided by Bernstein and said that this value is independent of stock call accuracy.

SUMMARY

While the case for quality and independence is open to some debate, we believe IRPs are able to offer a number of distinct benefits when compared to research provided by investment banks, including:

1. In-country, on-the-ground coverage (i.e. research is not centralised out of a central hub like Hong Kong);
2. Small and nimble operations whose primary focus is on insight generation (as opposed to churning out “maintenance” research updates); and
3. The ability to provide unconstrained opinions that are not tied to a bank’s ECM relationships or secondary trading businesses.

In a post-MiFID II world, we see a very compelling business case for the use of IRPs by fund managers and forecast a continued shift in research wallet from incumbent providers (i.e. the global investment banks) to high quality, independent content providers.

WE SEE A VERY COMPELLING BUSINESS CASE FOR THE USE OF IRPS BY FUND MANAGERS AND FORECAST A CONTINUED SHIFT IN RESEARCH WALLET FROM INCUMBENT PROVIDERS (I.E. THE GLOBAL INVESTMENT BANKS) TO HIGH QUALITY, INDEPENDENT CONTENT PROVIDERS.

SECTION 4

ALTERNATIVE RESEARCH MODELS

OVERVIEW

Given the numerous challenges facing investment banking research departments and the advantages of using IRPs, we believe sell-side players may wish to consider exploring alternative models for their research platforms.

In this section of the report, we explore the relative merits of three distinct broker operating models in a post-MiFID II world, including:

1. A fully-integrated brokerage providing its own proprietary research;
2. An execution-only brokerage offering branded research out of a research joint venture; and
3. An execution-only brokerage sourcing content from IRPs (see Figure 10).

MODEL 1: INTEGRATED OFFERING

The majority of brokers remain focused on offering their own proprietary research content through a fully integrated primary and secondary investment banking platform (see Figure 11).

WE BELIEVE SELL-SIDE PLAYERS MAY WISH
TO CONSIDER EXPLORING ALTERNATIVE
MODELS FOR THEIR RESEARCH PLATFORMS

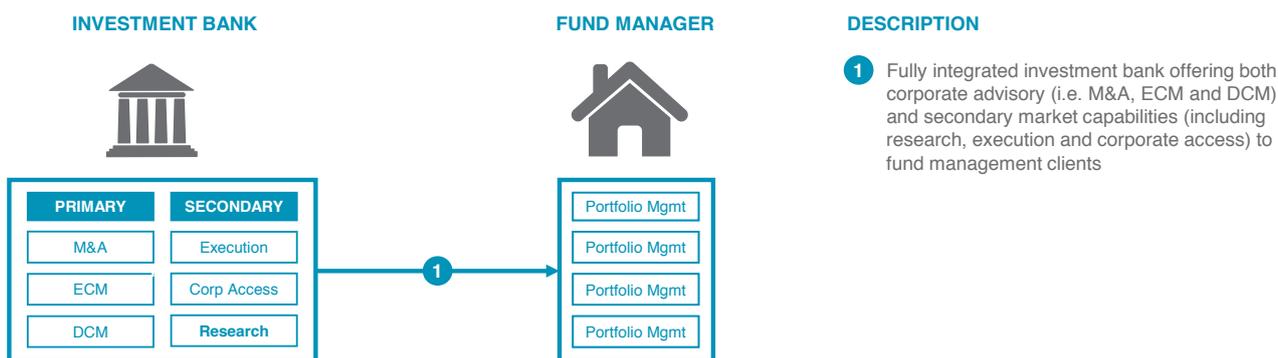
FIGURE 10: ALTERNATIVE BROKER RESEARCH MODELS

	MODEL 1 INTEGRATED OFFERING		MODEL 2 SEPARATED OWNERSHIP		MODEL 3 OUTSOURCED RESEARCH	
	Waterfront	Specialised	Controlled	Non-Controlled	Independents	ORMs
Example						
Description	Proprietary research offering across all key regions, products and industries	Proprietary research coverage focused on key regions, product and/or industries	Research provided out of a separate entity that is wholly/majority-owned/controlled	Research provided out of a separate entity that is minority-owned/controlled	Research sourced from preferred group of independent research providers	Research content sourced from various providers through an aggregation platform
P&L Impact	✘	✘	-	✓	✓	✓
Support for Primary Business	✓	✓	✓	-	-	-
Support for Trading Business	✘	✘	✘	✘	✘	✘
Conflict of Interest	✘	✘	-	-	-	✓
Operational Manageability	✘	✘	-	✘	✓	✓
Brand Visibility	✓	✓	-	-	-	✘

✘ Unfavourable
 - Conditional
 ✓ Favourable

Source: Quinlan & Associates analysis

FIGURE 11: INTEGRATED OFFERING



Source: Quinlan & Associates analysis

On one end of the spectrum, bulge bracket investment banks (such as UBS and Morgan Stanley) are looking to offer buy-side clients waterfront research coverage across all key regions, products, and industries. On the other end of the scale, smaller full-service brokers (such as Kepler Cheuvreux and Berenberg) provide more targeted research coverage focusing on a specific region/ geography.

KEY ADVANTAGES

While brokers producing their own proprietary research will be able to generate separately identifiable income streams for their content post-2018, we see top-line revenue pressures mounting as the buy-side becomes increasingly more disciplined around their research consumption habits. We believe that brokers will need to scale back their waterfront coverage offering to focus on key products, sectors, and geographies where they have a competitive niche, given the difficulty in monetising content from lower ranked analysts/ teams.

The ability to produce proprietary research offers natural support to a bank’s primary capital markets business, especially its ECM franchise. Much of this relates to the fact that bankers can present a “house view” during their pitching/roadshow efforts. This is also important from the perspective of maintaining a broker’s own brand visibility.

KEY DISADVANTAGES

In light of the recent report by the FCA (see Section 1), the merits of providing in-house research to support a bank’s ECM business are likely to come under considerably more scrutiny in years to come, given the potential conflicts of interest associated with connected research produced by analysts within investment banks that are part of the IPO’s book-running syndicate. Moreover, given MiFID II’s directive to divorce research spend from trading volumes, the value of research in driving a broker’s secondary trading revenue has been significantly depleted. Taken together, these will weigh heavily on the business case for integrated investment banks post-2018.

It is also clear that maintaining investment research capabilities in-house is proving extremely expensive for global brokers. As highlighted in Section 1, much of this is due to allocated cost mechanisms that exist at global banks, leaving them with far less pricing firepower than IRPs. As it stands, the combination of top-line revenue pressure and a sticky cost base is likely to see many investment banking research departments experience negative P&L outcomes post-2018. Added to this, the process of managing research in-house is likely to become increasingly complex as banks scramble to address their heavy compliance obligations under MiFID II.

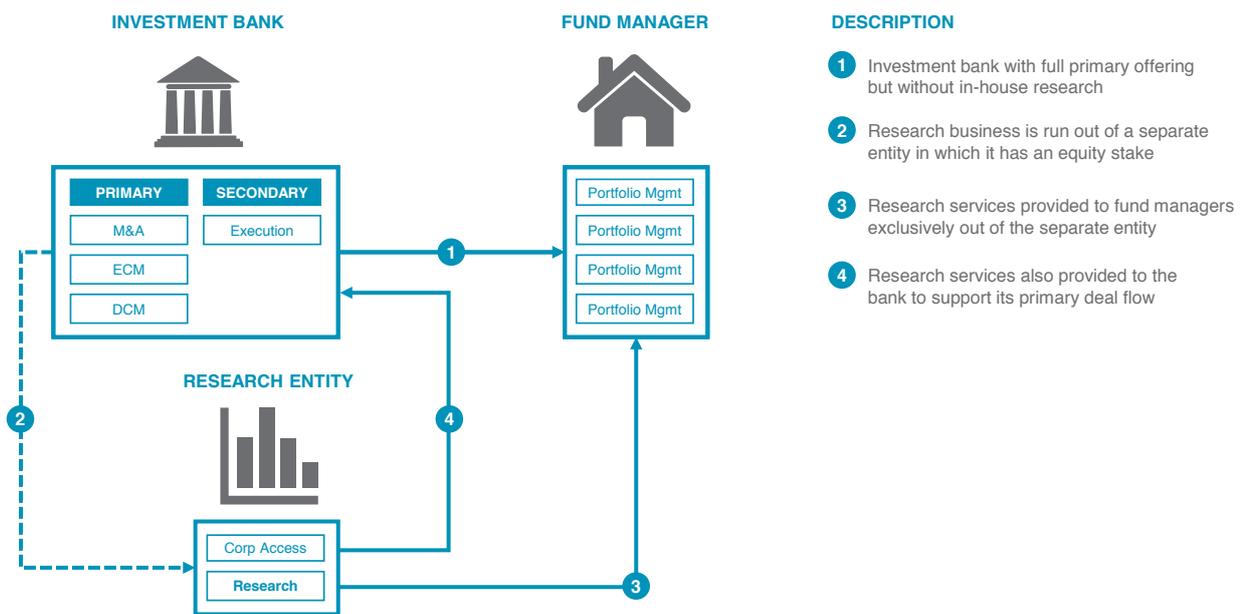
We believe pricing models akin to Macquarie Dimension's (i.e. a low subscription price for unlimited access to online content, with additional fees for value-add services on an as-needed basis) appear to be the most workable fee structure being showcased by the global firms at present, though we still caution any temptation by global banks to "loss lead" with their written research (see Section 1).

MODEL 2: SEPARATED OWNERSHIP

To address some of the disadvantages associated with operating a fully integrated brokerage platform, some investment banks may wish to explore the creation of a separate research entity, which may involve the formation of a joint venture (JV) (see Figure 12).

THE COMBINATION OF TOP-LINE REVENUE PRESSURE AND A STICKY COST BASE IS LIKELY TO SEE MANY INVESTMENT BANKING RESEARCH DEPARTMENTS EXPERIENCE NEGATIVE P&L OUTCOMES POST-2018.

FIGURE 12: SEPARATED OWNERSHIP



Source: Quinlan & Associates analysis

One of the most notable examples of a successful research JV is Exane BNP Paribas, a tie-up between Exane Partners and BNP Paribas that was established in 2004. The firm performs fundamental, long-term research on more than 600 Pan-European stocks and boasts over 250 analysts, sales, sales-traders, and traders among its employee base. It is also the exclusive distributor for European ECM transactions originated by BNP Paribas. Exane BNP Paribas ranked 1st overall in equity research and sales in Exel's 44th annual pan-European survey in June 2017.

According to the firm's website, the three core pillars of its partnership include:

1. An **operational partnership** in European cash equities where BNP Paribas conferred exclusivity to Exane under the Exane BNP Paribas brand;
2. A **balance sheet partnership** which is particularly well suited to the firm's Derivatives business, providing financing and support for Exane's rating; and
3. A **capital partnership** uniting the strength of BNP Paribas with the independence of Exane.

Exane Partners holds 50% of the capital and 60% of the voting rights in the entity, while BNP Paribas holds 50% of the capital and 40% of the voting rights.

KEY ADVANTAGES

Operating a bank's research business out of a separately-owned entity has the potential to reduce perceived conflicts of interest if the bank's research is branded distinctly under a newly-named operating unit. P&L is also likely to improve, given the platform can function without the burden of substantial central cost allocations from an integrated bank.¹² For example, for its 2016 fiscal year, Exane BNP Paribas booked a net profit of €43m on an income of €401m. The firm has operated at a cost-to-income ratio of ~80% for the past two years, considerably better than the cash equities businesses of many of its bulge bracket peers.

Investment banks opting to take non-controlling stakes in JVs stand to receive significant cost and headcount benefits; as the entities are not consolidated, all direct costs tied to their research business, as well as a large share of allocated costs, will be removed from the banks' P&L. With substantial top-line revenue pressure forecast for global brokers post-MiFID II, cost reduction should remain a core strategic priority.

KEY DISADVANTAGES

Compared to operating an integrated brokerage platform, operating a research business out of a separate entity may come with potentially lower brand visibility, though this will largely depend on the naming protocol of the new entity.

For an investment bank holding a non-controlling stake, careful consideration will need to be given to the governance structure between the entity and the bank itself. In worst case scenarios, strategic and cultural differences between any partners (such as a misalignment in client/product focus or management styles) could lead to a breakdown in the relationship, especially in the case of a JV. In particular, without operational control, a minority partner may also fail to exert meaningful strategic influence over the platform.

The pitfalls of operating minority-controlled JVs can most clearly be seen with Sino-foreign securities JVs, in which foreign firms have generally been limited to a maximum stake of 33%. Many of the early JVs have been dissolved and the majority of those remaining have failed to achieve meaningful profitability since they were launched.¹³ Whilst we recognise cultural nuances associated with operating in China may have exacerbated such problems, we nevertheless believe it is important for investment banks to manage any JV relationship carefully.

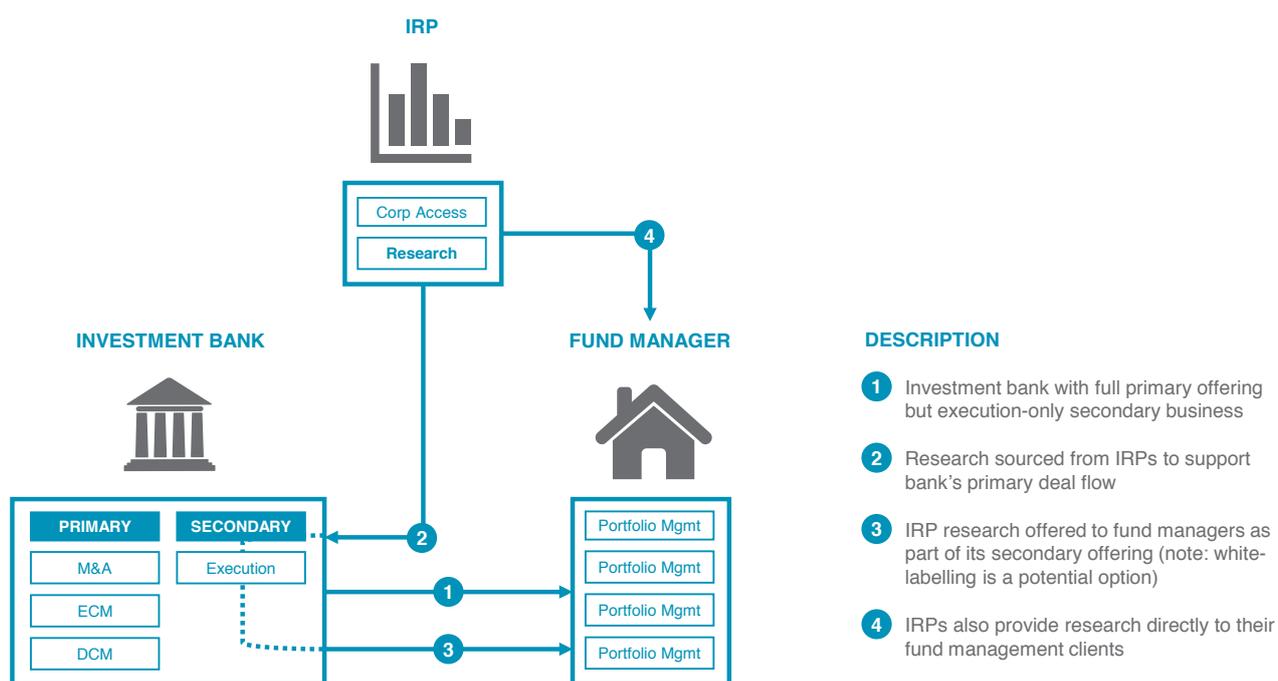
MODEL 3: OUTSOURCED RESEARCH

Given some of the strategic and operational complexities tied to operating research out of a separately-owned entity, as well as the downside P&L implications of operating as a full service brokerage post-2018, investment banks may wish to consider shutting down their internal research arms and sourcing their content needs from IRPs – either using a select group of preferred providers or through an online research marketplace (ORM).

¹² This potential benefit would also apply to non-controlled JVs branded as distinct entities

¹³ Quinlan & Associates, 'Sino-Foreign Securities Joint Venture: Round 2,' September 2016, available at: <http://www.quinlanandassociates.com/insights-sino-foreign-securities-joint-ventures/>

FIGURE 13: MODEL 3 – OUTSOURCED RESEARCH



Source: Quinlan & Associates analysis

A recent example of an investment bank that has gone down this path is Société Générale (SocGen) which, in December 2016, announced a partnership with Smartkarma. The tie-up provides SocGen's institutional clients with access to Smartkarma's investment research platform, as part of a package of services offered to their clients. Given SocGen does not offer in-house research in Asia, this tie-up provides a broader service offering to SocGen's clients without the need to build content internally. Smartkarma has also benefited from adding a significant number of new users to its platform.

KEY ADVANTAGES

We believe integrated investment banks stand to realise substantial P&L benefits from sourcing their investment insights from IRPs.

While we anticipate global research spend to decline by up to 30% by 2020, we believe bulge bracket investment banks will see their research income fall by up to 40% as managers rationalise their purchase decisions and IRPs capture a greater share of the global research market. With many investment banks' equities businesses operating at cost-to-income ratios of ~90%, the need to reduce costs is of paramount importance.

Sourcing research from IRPs also allows investment banks to address potential conflicts of interest through the provision of unbiased, independent insight to their clients. Despite lacking their own “house view”, banks could also look to market this impartiality as a way to support their primary market deal flow. Most importantly, through focusing on their core, value-add capabilities (such as deal origination and trade execution), banks can streamline their operating models considerably. This operational streamlining will be particularly evident post-2018, when global banks become burdened with a host of new regulatory and compliance obligations under MiFID II that many of the IRPs have already addressed.

KEY DISADVANTAGES

While we anticipate conflicts of interest to diminish under an outsourced research model, this will only be the case for those banks who source their insights from truly independent IRPs (i.e. firms who do not engage in sponsored research, where there is likely to be inherent bias).

By shuttering their own investment research departments, banks will undoubtedly lose some brand visibility in the market, unless they choose to “white label” content that is provided by their preferred IRPs. Moreover, there may be a negative impact on their primary business if the IRP provides a negative outlook on companies a bank is looking to engage in potential transactions with. However, we believe content objectivity will only benefit the capital markets industry in the long-run, ensuring only the best deals come to market.

SUMMARY

It is clear that each of the three research models outlined above comes with its own unique selling points, as well as disadvantages. However, when viewed as a whole, we believe the business case for continuing to operate an integrated brokerage platform is rapidly deteriorating, while the financial, strategic, and operational merits of exploring alternative research models cannot be ignored.

SECTION 5

CASE STUDY

We had the opportunity to interview the team at Smartkarma, an Asian-based online research platform which extends its service offering beyond the aggregation of research, allowing independent research providers to interact and collaborate amongst themselves, and engage with research users.

BACKGROUND

Smartkarma was set up in 2014 by a team of buy- and sell-side professionals looking at where fintech had yet to impact the status quo. In the investment research space, the introduction of PDF reports in the early 1990s was commonly seen as the last major innovation. Smartkarma saw regulatory changes surrounding unbundling as the necessary impetus to disrupt the investment research market.

Currently, Smartkarma has over 140 research providers – Smartkarma calls them Insight Providers or IPs – covering approximately 1,600 companies in 15 markets across the region. Certain US and European companies with Asian operations are also covered by its IPs. Over 500 reports or “insights” are now published through Smartkarma each month.

Smartkarma also aims to cover areas historically under-covered by the research departments of traditional brokers due to the economics of coverage. Niche focus areas include IPOs & placements, event driven / special situation, and small and mid-cap equities.

THE PLATFORM

USER EXPERIENCE

Following registration, users can define their investment mandates by selecting countries, sectors, and market capitalisation. Further refinements by “Verticals” – such as thematic, event-driven, technical analysis-driven, or macro research – can be selected. The platform recommends IPs for its users to “follow” based on the investment mandate chosen. Specific companies can also be followed by users.

On the main dashboard (see Figure 14), the Insights tabs show in real-time: (1) insights based on a user’s personalised filter; (2) what is trending based on what other users are reading; and (3) the latest insights that have been published. Insights are simultaneously disseminated across the Smartkarma platform, via social media, and syndicated onto Bloomberg at the time of publication.

The Discussion Stream is a live stream of the various group chats generated off the back of insights. When we viewed the highest trending insights, we noted very comprehensive engagement from fellow IPs, with chats eliciting content-rich responses of between 150 to 300 words. Users can also initiate private message chats with IPs – we expect that research users will be more likely to engage in this manner.

Being a cloud-based platform, Smartkarma can be accessed via mobile devices. Different watchlists can be customised, with personalised insights delivered as real-time alerts and/or regular scheduled emails.

FIGURE 14: SMARTKARMA – DASHBOARD

The dashboard is organized into several main sections:

- Insights:** A list of articles with filters for 'My Reading List', 'Trending', and 'Latest'. The 'Latest' filter is active, showing five articles:
 - United States:** 'Revisiting Trump's 100 Days in Office' by Anand Ramachandran / Macro (2 May 2017 19:08)
 - China:** 'Signs of Chinese Slowing and What This Means for Q2-Q3' by Christopher Balding / Macro (2 May 2017 17:59)
 - India:** 'Discretionary Demand Recovers While Staples Continue to Languish' by Bhaskar Chakraborty / Thematic & Strategy (2 May 2017 17:56)
 - TPG Telecom Ltd:** 'Corporate Action: Take Up TPG Telecom's AUD 5.25 Retail Entitlement Offer Before May 1...' by Morningstar / IPOs & Placements (2 May 2017 17:35)
 - Thematic & Strategy:** 'Fintech - Anything but Alternative (Part 4: Data&Software, Insurtech, Digital Banking, Ass...)' by GP Bullhound / Thematic & Strategy (2 May 2017 17:30)
- Discussion Stream:** A vertical list of discussion posts:
 - Christopher Balding:** Response to 'Signs of Chinese Slowing...' (2 May 2017 19:54)
 - Howard J Klein:** Response to 'Asian Credit Monitor: China - The Detrimental Debt Denota...' (2 May 2017 19:45)
 - Valerie Law, CFA:** Response to 'Signs of Chinese Slowing...' (2 May 2017 19:44)
 - Athaporn Arayasantiparb, CFA:** Response to 'Asian Credit Monitor: China - The Detrimental Debt Denota...' (2 May 2017 19:39)
 - Warut Promboon:** Response to 'Asian Credit Monitor: China - The Detrimental Debt Denota...' (2 May 2017 19:38)
 - Athaporn Arayasantiparb, CFA:** Response to 'Dawn of the Trump Era: Loy Kratong & Thematic Small Caps' (2 May 2017 19:26)
 - Howard J Klein:** Response to 'Asian Credit Monitor: China - The Detrimental Debt Denota...' (2 May 2017 19:04)
 - Julian Yoon:** Response to 'Memory Chip Crisis - Oversupply Threat Is Not Imminent' (2 May 2017 18:53)
- Insight Providers:** A list of providers with filters for 'Trending' and 'New':
 - 1. **Travis Lundy:** Pan-Asia Catalysts/Events/Activism... (Following)
 - 2. **Douglas Kim:** North Asia/IPOs/Fundamental/Catalysts
 - 3. **Sanghyun Park:** Korea-focused Equity Analyst, 15 Yrs of...
 - 4. **Nicolas Van Broekhoven:** NVB Asia Pte Ltd
 - 5. **Toh Zhen Zhou:** Smartkarma Innovations
- Entities:** A list of entities with filters for 'Trending' and 'New':
 - 1. **ING Life Insurance Korea Ltd:** South Korea (Watchlist)
 - 2. **M1 Ltd:** Singapore
 - 3. **Panahome Corp:** Japan
 - 4. **Netmarble Games Corporation:** South Korea
 - 5. **Toshiba Corp:** Japan
- Tools:** A list of analytical tools:
 - HoldCo Monitor:** Inspect Holding Company Structures and accurat...
 - IPO Analyser:** Data-driven analysis of risks and opportunities a...
 - M&A Analyser:** Analyse active M&A deals and calculate risk adju...
 - M&A Statistics:** Analyse historical deals since 2011, estimate co...
- My Locker:** A section for saved items, currently showing 'Retail Malls: Rest in Peace? Not so Soon ...'

Source: Smartkarma, Quinlan & Associates analysis

PRICING AND SUBSCRIBERS

There is a flat subscription fee for each user which allows unlimited access to content and the ability to interact with IPs. We understand that current users include traditional asset managers, hedge funds, endowment funds, sovereign wealth funds, and family offices.

Smartkarma's partnership with SocGen at the end of 2016 saw them add a significant number of new institutional users to its platform.

ADVANCED CONTENT MANAGEMENT

Algorithms have been developed to automatically tag publications according to the content, although IPs can also manually tag relevant key words. Keyword tags allow easier filtering of content.

Another concept that Smartkarma has introduced is called "forking". Publications with sufficient nexus can be grouped together either automatically via algorithms or manually tagged by the publishing IPs. This provides users with an easy reference for a particular topic, as well as other topics which may pivot from it. Insights on an ongoing topic – for example, an infrastructure company building a major asset – are grouped together. An insight about a particular company's supplier relationships can also pivot to publications about those suppliers.

WORK EFFICIENCY TOOLS

Several work efficiency tools have been developed by Smartkarma. One is a standardised chart creation application that follows Smartkarma's branding protocols, allowing IPs to save time on the visual presentation of their intellectual content. Another tool, called HoldCo Monitor, quickly pulls up the holding company discount to net asset value (NAV) and NAV composition for companies in the coverage universe. Other tools support IPO and M&A analysis.

Separately, the main dashboard includes a "My Locker" area which users can treat as a working space to develop ideas. Users can pin insights here, make notes, upload documents and add web links. Search functionality typical of the rest of the platform is also available in "My Locker".

We expect the company to continue to augment the stable of work efficiency tools that can be used by both research providers and consumers.

COMPLIANCE ASPECTS

Smartkarma is registered in Singapore and classified as an Internet Content Provider under the Singapore Media Development Authority's Class Licence Scheme. It is not registered or licensed as a "financial adviser" under Singaporean legislation and regulation. As a result, there are no stock recommendations or price targets. As we have noted earlier, however, its bull-to-bear ratio has been approximately 60:40 since inception.

Compliance safeguards have been built into Smartkarma to "future proof" against future changes in regulation. A recent enhancement allows compliance officers from a user organisation to monitor and download activity for their internal reporting requirements.

THE PROPOSITION FOR RESEARCH PROVIDERS

HOW TO JOIN

Currently, IPs are recruited via direct enquiries, referrals from current IPs, or actively sought out by the Smartkarma team. A multi-step vetting process includes the submission of written research work, a review of experience and submissions, and an interview. IPs are then provided with a trial period to observe the platform without publishing.

To add depth to the insight contributions, the company has opened up the platform to non-traditional research providers, including academics, lawyers, and data scientists.

REMUNERATION

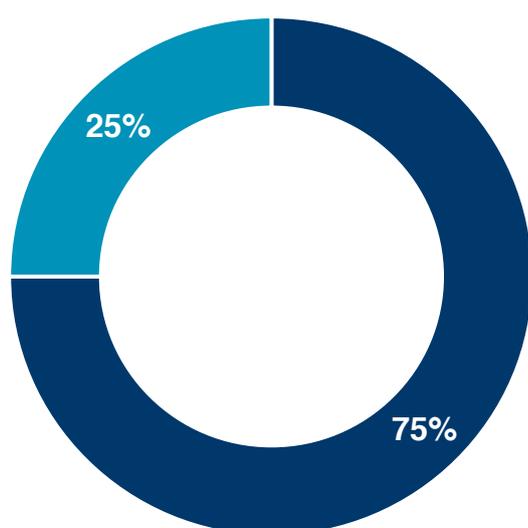
For research providers, the company provides a unique remuneration proposition. More than two-thirds of monthly subscription revenues are paid out to IPs based on a Smartkarma-coined term and methodology, called Quantified Value Add or QVA. Determined by more than twenty metrics, QVA is an index of the total value that Smartkarma provides to consumers, and is used to determine the sharing of the revenue pool amongst all IPs. The two key variables measured by QVA are engagement and collaboration.

Engagement measures levels of interaction with consumers, including the quality of that interaction. We understand that it discounts the “noise” from simple clicks on a report, but takes into account aspects such as users proactively reaching out to IPs, and the IP’s follow-up actions. 75% of QVA is determined by engagement.

Collaboration measures interaction amongst IPs, including peer reviews of reports prior to publication. It also serves the purpose of supporting and developing newer IPs, especially those making the move to an independent research analyst set-up, or those expanding beyond their traditional domestic audience. 25% of QVA is determined by collaboration (see Figure 15).

ENGAGEMENT MEASURES LEVELS OF INTERACTION WITH CONSUMERS, INCLUDING THE QUALITY OF THAT INTERACTION. WE UNDERSTAND THAT IT DISCOUNTS THE “NOISE” FROM SIMPLE CLICKS ON A REPORT,

FIGURE 15: QUANTIFIED VALUE ADD (QVA)



ENGAGEMENT

- Measures the level and quality of interaction with consumers
- Discounts “noise” from simple report clicks
- Takes into account proactively reaching out to IPs, as well as IP follow-up actions

COLLABORATION

- Measures the level of interaction among IPs
- Examines criteria such a peer review and feedback prior to report publication

Source: Smartkarma, Quinlan & Associates analysis

Monthly payments to IPs are based on a rolling three-month QVA, in order to smooth QVA income during breaks from work. This adds to work flexibility, especially for independent analysts. Since April 2016, total payments to IPs have increased over 140%, reflecting the increase in subscriber base.

PULL-FACTOR RESEARCH

A discovery scoring tool that has recently been released allows IPs to understand which topics or companies users are most interested in, compared to the research that is currently available. This investment research supply-demand “gap analysis” allows IPs to be more strategic around where they focus their publishing efforts.

Some research providers, especially the larger firms, continue to use the platform as a traditional research push platform to distribute their research, whilst other research firms allow their analysts to develop an individual, online, and engaged presence on the platform.

SUMMARY

For users, Smartkarma is attempting to differentiate itself through new and alternative content, the curation of content both through its upfront selection of IPs and smart algorithms to filter content, and dynamic engagement between users and IPs. It not only offers Asian-focused content, but also newer content verticals such as accounting, financial risk, and big data analytics, which are not typically covered by the larger brokers. We believe Smartkarma's bull-to-bear ratio of ~60:40 is a telling indicator of the independence of the IPs publishing on the platform.

The Smartkarma-SocGen tie-up was a major breakthrough for the industry and we expect to see other tie-ups between ORMs and broker firms in the months ahead.

For IPs, Smartkarma is not just a content distribution platform – through the use of content and work management tools, it is also a publishing platform. And whilst the platform is heavily reliant on technology, the humanistic aspects incorporated into the platform are particularly thought-provoking. These include the collegiate support network for IPs where desired behaviour is directly reinforced through remuneration, and QVA income smoothing which provides income stability.

By designing a platform that places as strong an emphasis on supply as demand, we expect Smartkarma to be an attractive proposition to even highly-ranked research analysts looking to move to a more independent set-up. As the number of IPs increases, we expect that Smartkarma's main challenge will be in ensuring the quality of IPs and their content is maintained.

FOR IPS, SMARTKARMA IS NOT JUST A CONTENT DISTRIBUTION PLATFORM – THROUGH THE USE OF CONTENT AND WORK MANAGEMENT TOOLS, IT IS ALSO A PUBLISHING PLATFORM. AND WHILST THE PLATFORM IS HEAVILY RELIANT ON TECHNOLOGY, THE HUMANISTIC ASPECTS INCORPORATED INTO THE PLATFORM ARE PARTICULARLY THOUGHT-PROVOKING.

SECTION 6

P&L IMPLICATIONS FOR BROKERS

As highlighted in Section 4, beyond the strategic and operational benefits that integrated brokers stand to receive from exploring alternative research models, we expect MiFID II to have a negative impact on the P&Ls of many leading investment banks.

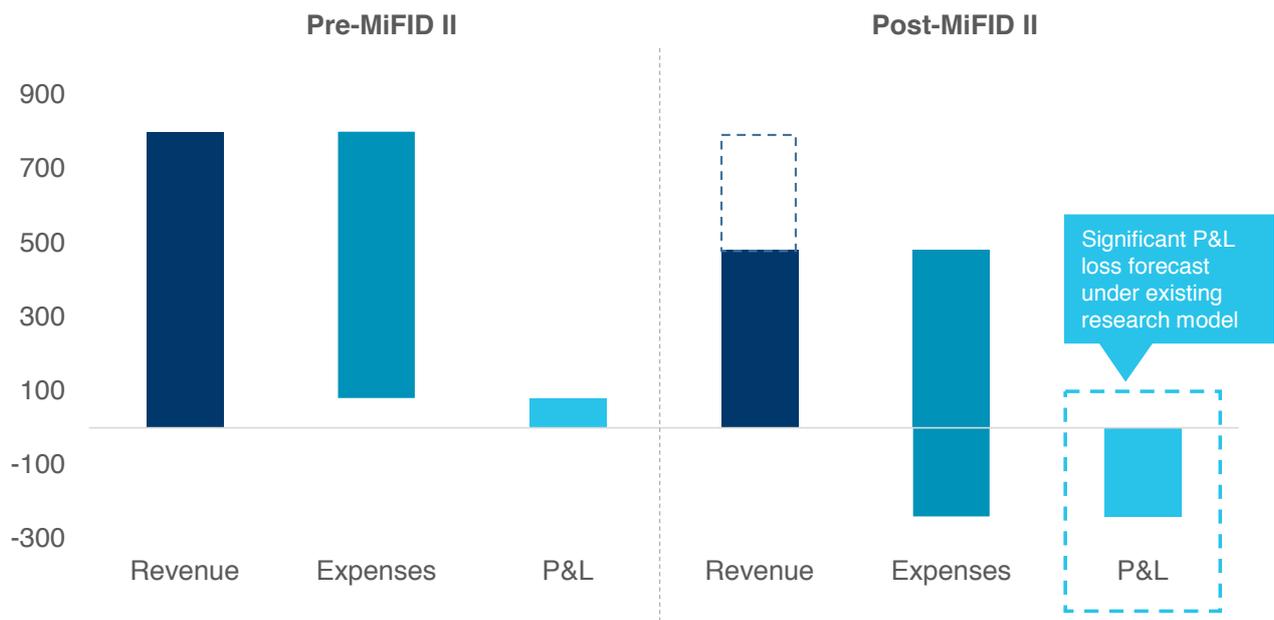
Based on our discussions with various industry experts, we estimate the largest global banks are spending anywhere between USD 600-800 million per year on their research platforms (USD 300-450 million for tier-2 global firms) on a fully-loaded basis. More critically, many of these banks' cash equities platforms (i.e. the research distribution engines of the equities businesses) are currently operating at cost-to-income ratios in excess of 90%.

With research revenues forecast to decline by ~40% for some of the largest investment banks, we anticipate some research departments to be underwater to the tune of USD 240 million post-MiFID II under their current structures (see Figure 16). This does not take into account additional costs tied to a bank's MiFID II compliance obligations.

Given the negative outlook for integrated brokerages, we feel current structures are generally unsustainable, and believe brokers will need to make a brave call around their future business models post-2018.

WE ANTICIPATE SOME RESEARCH
DEPARTMENTS TO BE UNDERWATER TO THE
TUNE OF USD 240 MILLION POST-MIFID II
UNDER THEIR CURRENT STRUCTURES

FIGURE 16: P&L IMPACT OF MiFID II ON LEADING GLOBAL BROKERS



Source: Quinlan & Associates estimates

SECTION 7

HOW CAN WE HELP?

Our consultants have worked with a number of brokers, buy-side players, and IRPs on their strategies in response to MiFID II's research unbundling regulations.

SELL-SIDE

The sell-side faces considerable challenges realigning their businesses in the wake of the structural changes affecting the industry. Immediate decisions will be needed to remain competitive in the short-term. However, we believe a fundamental rethink of research provision within sell-side firms is ultimately required. Examples of how we can help include:

- Evaluating alternative options for investment banks' research product offering, including the financial, strategic, and operational considerations of new models such as JVs and outsourced research
- Conducting client-level profitability segmentation analyses to improve coverage decisions
- Benchmarking performance of research offering to drive product recalibration decisions
- Developing workable research pricing schedules to maximise firm economics and client demand

BUY-SIDE

We recognise many buy-side firms are still extremely unprepared for MiFID II implementation, especially players in Asia-Pacific. Examples of where we can help include:

- Assessing the impact of regulations on current business models, broker interactions, service offerings, and governance models, especially for regional businesses
- Determining an appropriate research payment option (i.e. P&L vs. RPA)
- Developing a methodology for research budget setting and monitoring (including setting up KPIs)
- Reviewing and developing an in-house research strategy

INDEPENDENT RESEARCH PROVIDERS

As we have indicated in Section 3, changes in the research landscape provide the ideal timing for research analysts to re-evaluate their options, whether to join an IRP or to set up their own IRP. Examples of areas where we can help include:

- Developing strategic plans for IRPs to capture the new opportunities, including comprehensive reviews of their value propositions and unique selling points (USPs)
- Reviewing growth strategies, including branding, marketing, and scaling of the business
- Determining the most appropriate collaboration and distribution channels
- Introducing new entrants to potential collaborators
- Developing alternative revenue streams, including new markets and products

QUINLAN & ASSOCIATES

STRATEGY WITH A DIFFERENCE

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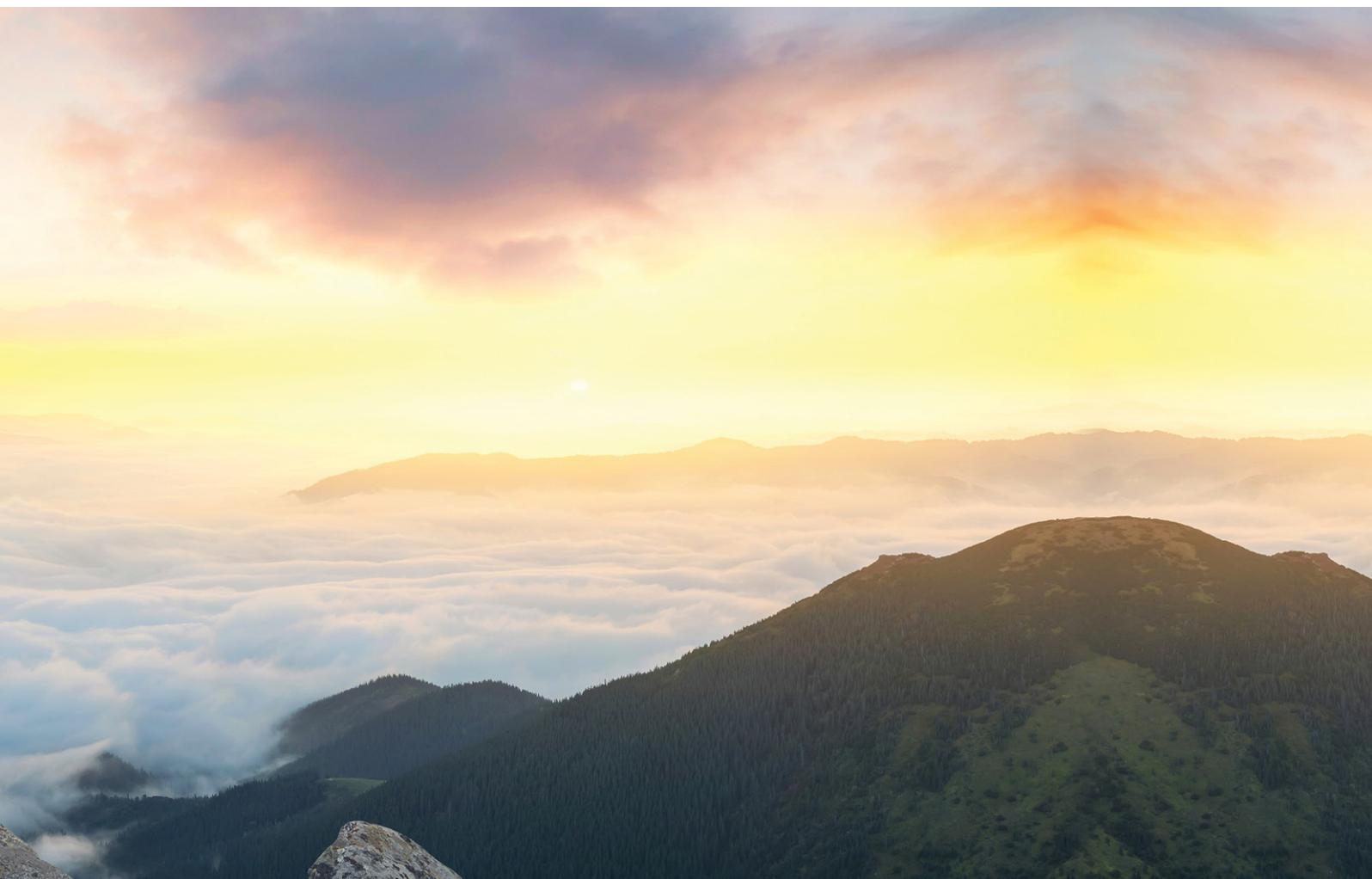
ABOUT US

Quinlan & Associates is an independent strategy consulting firm specialising in the financial services industry.

We are the first firm to offer end-to-end strategy consulting services. From strategy formulation to execution, to ongoing reporting and communications, we translate cutting-edge advice into commercially executable solutions.

With our team of top-tier financial services and strategy consulting professionals and our global network of alliance partners, we give you the most up-to-date industry insights from around the world, putting you an essential step ahead of your competitors.

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