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Sidoti is broader than Sidoti

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SNL contributor Ada Lee had a recent post on *The Wall Street Journal*'s story about Sidoti & Co.'s "buy" and "neutral" rating system and other issues research as a business unit is grappling with. If you have not read her post, it is worth your time. Her comments usually have a biting reality. Also, SNL senior reporter Joe Mantone, who covers topics related to Wall Street, had a recent post on the importance of research for some investment banks. I mused in January about research in this column, too. I want to add my two bits here about Sidoti, but I raise a different question.

Sidoti garnered widespread attention in the financial press when the *Journal* ran a story on the company's pending IPO, its two-tier rating system of "buy" and "neutral" that excludes "sell" and a whistleblower complaint. Randall Forsyth, who pens *Barron's* widely read "Up and Down Wall Street" column, poked fun at the company with a comparison to Garrison Keillor's Lake Wobegon where everyone is above average. It is not the type of coverage Sidoti was looking for as part of its planned IPO when it hopes to raise up to $35 million.

I am not endorsing Sidoti's approach to ratings, although "sell" or "underperform" seems like the more logical antonym to "buy." Regardless, I completely agree with Lee that institutional investors do not care about ratings. They care about an analyst's knowledge of a company, the industry and how the knowledge can be weaved into an investment thesis for a given company or industry. Presumably institutional investors find Sidoti's coverage of under-followed micro- and small-cap companies useful for this reason.

I offer one caveat regarding ratings, however. I think some hedge funds can care a lot about ratings changes to the extent a change becomes a short-term catalyst for the shares — especially if the subject company is controversial and heavily shorted. This has nothing to do with investing, and everything to do with the short-term moves in stocks that many hedge funds care about. Of course, hedge funds are a major source of revenue for Street trading desks.

I think the bigger "Sidoti" issue is a subject I raised in the December 2013 post: management (or corporate) access. It is a concierge service whereby the sell-side arranges meetings with companies that are covered (or potentially will be covered) with the buy-side. It is something the buy-side could do on its own, but relies extensively on the Street to bring management teams into their office or coordinate management visits at a sponsored conference, dinner or other gathering. I believe it is a service that grew in importance last decade after Eliot Spitzer forced the formal (but not informal) divorce of banking and research and the decimalization of trading that narrowed spreads.

As a business, sales/trading/research remains under pressure to sustain revenues. Greenwich Associates estimated for the 12 months ended in February 2015 that U.S. cash equity commissions declined 5% to $9.8 billion. In 2009, Greenwich estimated industry commissions were $14.0 billion. Sidoti's trends were comparable with revenues of $25.5 million in 2014 compared to $30.3 million in 2013 and $5.3 million in the first quarter compared to $7.6 million in the first quarter of 2014. The pretax margin in 2013 and 2014 was just under 3% each year.

Management access is an important component of research's contribution to institutional commissions, a portion of which reflects payment for execution compared to bundling to pay for research. While I cannot find any definitive numbers, my view is that 30% to 40% of commissions are attributable to management access. I think most sales/trading/research professionals would support my view. Regardless, the issue is sufficiently important for Sidoti to note in its S-1 that it arranged 996 meetings in 2014 compared to 1062 in in 2013 and 123 during the first quarter of this year compared to 243 in the first quarter of 2014.

As Lee notes, companies are the primary constituent that cares about analysts' ratings. Managements are charged with promoting the companies among investors on behalf of shareholders, and most have significant investments in their companies. My experience is that companies are even handed in terms of who they travel with as long as the rating is positive or neutral, which is the vast majority of ratings on any given day. Those with bullish views following an upgrade may move up the list. Those with the infrequent sell rating (Lee described this as finding a unicorn) or more common neutral rating with a clear negative bias are put in a penalty box until an upgrade occurs. Controversial companies can be more selective and may be more likely to travel only with analysts they view as promoters.

If management travel with the firm is important to generate commissions, then human nature is going to make it harder for analysts to be completely objective all of the time — especially at firms that do not have robust investment banking efforts that can subsidize thin margin equity capital markets units. But where I think the real conflict may be is on the other side of the house: the buy-side and its fiduciary duty to its asset management clients. Is it right to use client funds to allocate commissions for management access?

It is not an issue in the U.S., but it is in Europe where the European Commission is poised to ban or at least severely restrict the use of client commissions by the buy-side to pay for research. Last year the UK's Financial Conduct Authority banned the use of client commissions to pay for management access. In effect, the trend in Europe is to force the buy-side to pay for research with hard dollars.

From a research business model perspective, the issue should be watched to see if it gains traction in the U.S. It may not because Wall Street and publicly traded companies will be lined up against it. And the other access issue that I think is very safe is the favoritism that I believe the buy-side has to pay brokers with robust investment banking efforts to ensure that they get choice dibs on underwritings, especially IPOs. Arguably, the clients whose funds are invested benefit from this informal directing of commission. Plus, the largest firms probably offer the best or nearly best execution.

So, for all of the hand wringing about the business model, the importance or non-importance of ratings, and corporate access, I like what the independent equity research firm Cleveland Research Co. has to say, "We pride ourselves on a disciplined research process that has us regularly engaged with the companies we cover. We are focused mainly on uncovering inflection points via rigorous digging in the channel." Digging for shifts in the fundamentals of a company or industry is a great way to go about the business; though as a private company there is no way to know what its clients will pay for it.

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