Creating Visibility for Small Caps

Every company has challenges obtaining and maintaining analyst coverage. However, small-caps often face additional challenges — lack of brand name recognition, lower liquidity, stock price volatility and declining equity research.

By Louis M. Thompson, Jr.

With limited budgets and resources, any small-cap company needs to be resourceful and extremely persistent to raise its profile on Wall Street. Although every company has different limitations, there are simple outreach tactics that virtually all can employ.

Develop the Message

Before going to the Street, the senior management team must develop a clearly defined vision statement supported by a strategy and goals to achieve the vision. The company's investor relations officer or IR consultant should be involved at the outset in developing this statement. Next, a strong messaging platform is required. It is imperative that the company has a clear, single message that it is communicating both internally and externally. Investor relations and corporate communications must synchronize their messaging to investors, customers, employees, the media and other audiences.

Institutional investors tell us that before making an investment decision, they want to meet face-to-face with the CEO and CFO to assess the quality of senior managers and determine if they have a realistic and understandable strategy to get the company to accomplish its goals.

Next the company should make this information easily accessible to investors by incorporating it into an investor relations fact or data sheet, marketing packets and the company's Web site.

Sell-side security analyst coverage for micro and small caps has diminished drastically in recent years. The economics of separating sell-side research from investment banking relationships are driving many sell-side firms to reduce their research coverage, and as a result some companies have lost all sell-side coverage. So, what is happening to all of those brokerage firm analysts? Most have gone to buy-side firms, including the growing number of hedge funds, which are beefing up their internal research capability. So go where the action is. Network!

Get the Coverage

Many of the buy-side firms have screening criteria such as market-cap and investment style (e.g., EPS growth, momentum or long-term value). Many micro- and small-cap companies cannot even get on their radar screens because of their cap size. There are firms that provide targeting services that advise companies which buy-side firms to approach, thus saving them from wasting time using a "shotgun" approach.

So where is the buy-side going for research? Internal research departments top the list at 85%, sell-side firms come in at 8% and issuer-sponsored research comes in at 5%.

Equipped with that knowledge, many small companies ask investors with solid sell-side relationships to recommend their companies for research coverage. Others try to leverage the buy side to promote their companies to the sell side.

In addition, companies should provide key information that the buy side uses to make investment decisions. Rivel Research conducted a study last year of institutional investors and found that 83% named management credibility as the most important factor in making an investment decision. Credibility is measured primarily in terms senior management's integrity and candor, the company's ability to communicate an effective business strategy and its ability to meet or exceed its articulated goals. That same survey showed that earnings per share growth was mentioned by only 66%, demonstrating that there are more important factors than EPS growth, even though so many companies emphasize it.

Truly Independent?

Another option for companies seeking more coverage is to target independent equity research firms that focus on smaller companies with low market caps and a lack of a traditional Wall Street following.

There is unnecessary confusion over what is "independent research" and "issuer-paid research," which is also sometimes mistakenly labeled "independent." Independent research is performed by large firms like Sanford Bernstein as well as numerous boutique firms. They "sell" their research to the institutional investors. The subject companies do not pay for that research. In fact, some independent firms analyze companies without even talking with them.

Issuer-paid research is provided by firms that are engaged and paid by the subject companies. These are "independent" firms in that they are not owned by the companies they cover, but their research reports are not independent because they are not only paid for by the subject companies but published only upon approval of the companies and sent across a distribution list approved by the companies. Some of these reports do not contain a "buy" recommendation, which is reasonable since the reports do not have much credibility. Others gamely include a "buy" recommendation and a projected future stock price range as well. Sometimes such estimates appear to have no relationship to any of the standard valuation fundamentals. Purists prefer that company-sponsored research be prepaid in cash, but stock is often used (which, of course, further weakens the credibility of these reports). Indeed, stock is still is used to pay for many IR services.

In January 2005, the National Investor Relations Institute and the Chartered Financial Analyst Institute published guidelines for issuer-paid research to ensure all conflicts of interest and appearances of impropriety are avoided. This joint effort was prompted by the fairly common practice of so-called "investor relations firms" approaching mostly micro-cap companies and offering to conduct an "investor awareness" program or a similar campaign that would allegedly introduce them to the investment community through their research reports. Most of these firms offer this "service" in return for the company's stock or warrants but some do not fully disclose the compensation arrangement to potential investors. Some would go offshore and fax their "research reports" to investors in the U.S.

Many of those writing these reports were not qualified analysts. This clearly created an "investor-beware" situation. While the SEC has investigated some of these firms, the magnitude of the problem still requires more SEC attention.

While issuer-paid research can be a viable option for smaller companies, it is often fraught with potential conflicts of interest. Depending on how the research is written and distributed, investors can be misled into believing that the issuer-funded research appears to be from an independent source when, in reality, it is solicited and paid for by the company. Therefore, full disclosure of payment sources is essential to avoid such misconceptions. Cash is also preferred over stock so the analyst does not have a vested interest in hyping the stock. (See the sidebar insert for the new and very strict NIRI/CFA Institute Golden Rule Guidelines suggested for issuer-paid research.)

Two hybrids that attempt to bridge the gap between independent and company-sponsored research have emerged in the past year. The National Research Exchange, headed by former Nasdaq Vice Chairman David Weild IV, aims to bring together companies that will to pay the NRE for research coverage using one of more analysts from a stable of analysts provided by the NRE. The company may choose its analyst, but once it does it is locked into a multi-year commitment to stick with that analyst.

A similar concept, called the Independent Research Network, was announced jointly by Nasdaq and Reuters at NIRI's annual conference last June. The IRN's lock-in period is three years and Reuters provides the research capability.

In conclusion, the dynamic changes taking place the market today are creating even greater challenges for small companies to effectively communicate their message to the investment community. Gone are the days when companies could rely largely on the sell-side research and recommendations. Today, investor relations officers are spending the predominant part of their time going directly to the buy side and communicating their companies' message to decision-makers. If a company does not have an IRO, the CEO and CFO have to step up their efforts to communicate directly with investors.

"Above all, remember IR is vital to shareholder value and should not be neglected by top management. On important issues an outside IR consultant should not speak for the company to investors and analysts. Finally, in this age of instant global communications, every company must be ready to respond and communicate using an effective, integrated messaging platform to get your message out.

Retiring IR icon, Louis M. Thompson, Jr., is president and CEO of the National Investor Relations Institute, the professional association of corporate officers and investor relations consultants responsible for communications among corporate management, shareholders, security analysts and other financial publics. NIRI's 4,200 members represent more than 2,100 publicly-held companies in the United States.

Golden Rules for Sponsored Research

The National Investor Relations Institute and the Chartered Financial Analysts Institute have created these Golden Rule Guidelines for companies that hire analysts to produce research. Companies:

- Must engage only qualified analysts who are committed to producing objective and thorough research that fully discloses any matters that could reasonably be expected to impair their objectivity.
- Must not attempt to explicitly or implicitly influence the research, recommendations or behavior of the author(s).
- May compensate an analyst writing a research report in cash only and must not provide any compensation contingent on the content or conclusions for the research or the resulting impact on share price.

As for analysts, they must disclose in the report:

- The nature and amount of the compensation received for drafting the report.
- The nature and extent of any personal, professional or financial relationships the analyst, his or her firm or its parent, subsidiaries, agents or trading entities may have with the company, its personnel, parent, subsidiaries or agents.
- The author's credentials, including professional designations and experience that qualify him or her to produce the report.
- Any matters that could reasonably be expected to impair the analyst's objectivity in producing the report. The analyst must certify that the analysis or recommendations, if any, contained in the report represent the true opinion of the author(s).