Dwindling visibility for small and mid caps

MiFID II is throwing investment research into turmoil, and smaller listed companies are likely to be casualties, as **Steph Osborn** explains.

> **SMALL AND MID CAPS**
> - **Relationships between brokers and investors are becoming more transparent.**
> - **A significant reduction in sell-side coverage of smaller companies is expected.**
> - **For IROs, there needs to be a boost in resources to beat the visibility trap.**

The MiFID II regime that came into force in January has created some unintended side effects, especially within the field of investment research. Legislation that sought more transparency for investors is now threatening to choke off the supply of information that informs investors about opportunities within smaller listed companies.

The new rules crack down on the sell-side practice of sinking the costs of analyst research into transaction fees – the costs of any research must now be broken out and made transparent to all.

The immediate effect, according to a paper by Capital Access Group (CAG), will be a significant reduction in the amount of investment research. CAG forecasts that the number of sell-side analysts in the UK will fall by more than 50% during 2018, and by two-thirds over three years. It also predicts that UK fund managers will cut their spending on bought-in research from around £200m in 2017 to £90m in 2018. Some fund managers are choosing to build in-house research capacity.

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Small cap, low visibility

Large-cap companies are likely to be sanguine about the reduction in numbers of sell-side analysts, as most are currently over-served with dozens of analysts covering their stock. But small and mid caps, covered by far fewer analysts, may face diminished or zero coverage.

Exane BNP Paribas, in a recently-published MiFID II survey, stated: "For sell-side research houses, the economics of providing coverage on large-cap shares look set to become relatively much more attractive than covering small or mid caps. We expect to see a significant reduction in sell-side coverage of smaller companies."

It added: "While relationships between brokers and investors are becoming more transparent, the visibility of corporates in the European equity marketplace – particularly small companies – is shrinking… Both the number of sell-side analysts covering each stock and the number of investors they speak to are likely to decline. Many small investors will no longer have access to written sell-side research content at all."

Ironically, smaller listed firms, although inherently riskier, have a strong case for informed investment; over the last five years, the FTSE Small Cap Index delivered 13.2% annual return, whereas the FTSE 100 delivered 7.7%.

Pay to meet? No thanks

To add to the challenge for IR professionals, MiFID II is likely to undermine the traditional system in which brokers handled investor road shows and other corporate access on behalf of listed firms. Guidance issued by the European Securities and Markets Authority last year stated that broker costs around corporate access cannot be bundled with research, and must be properly charged at 'commercial' rates. According to CAG, now that costs are transparent, a majority of fund managers state that they will not pay brokers for meetings.

IR must step up

The good news for IR professionals is that they can beat this visibility trap by taking control of investor communications. But that's also the bad news, as it involves taking on extra tasks when IROs are already under a lot of pressure.

"Companies themselves will need to be much more proactive," Adam Kostyál, head of European listings at Nasdaq Nordic, told the *Financial Times*. "This will require more investment in investor relations and communications to make themselves visible."

Buy-side firms are likely to respond to the decline of sell-side research by approaching small/mid cap corporates directly, seeking information for their own analysts. IROs will need to develop the ability to respond very swiftly to all such requests, and will need to build a bank of in-house or company-sponsored research, along with a coherent suite of reports and stories about the company that explore not just financial performance, but also the company's values and principles.

The creation of a bank of communication assets will also allow IROs to reach out proactively to prospective investors, sending them compelling communications, organising their own roadshows and corporate access meetings directly with both current and new potential investors. Early indications are that overworked buy-side analysts are welcoming such approaches.

All this new outbound activity will inevitably require a boost in IR resources if it is to overcome the visibility trap. The choice for IR leads in small- and mid-cap firms is either adding people to their in-house team – communicators, designers, logisticians, share register experts, project managers – or partnering with external providers with the skills needed to help you reach out effectively to the investor community.

Acting decisively not only checkmates invisibility – it could improve and transform the way these firms communicate with all their stakeholders. ■