

# Increasing Market Visibility and Closing the Value Gap with Credible Issuer-Sponsored Research



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*The trading markets for public companies are assisted in great measure by the dissemination of quality investment research. Investment research coverage for public companies in general, and for smaller public companies in particular, has declined dramatically in recent years, however, as economic and regulatory pressures have led the financial industry to dramatically reduce research budgets. The problem is particularly pronounced in the case of small cap companies, of which less than half receive coverage by even a single analyst, and in the micro cap universe, where analyst coverage is virtually nonexistent.*

*-Final Report of the Advisory Committee on Smaller Public Companies; April 2006<sup>1</sup>*

## Background

An increasing scarcity of quality small cap company research coverage has been observed for well over 10 years. Historically, investment banks distributed research on covered companies to their buy side clients as part of a larger relationship that included lucrative trading fees. Investment banks were therefore able to subsidize large research departments with extensive coverage. The prospect of expanded investment banking relationships, with potential advisory fees in the six- or seven-digit range, offered further inducement for sell side research firms to maintain coverage on a large universe of public companies.

The January 3, 2018 implementation of the Markets in Financial Instruments Directive (“MiFID II”) represents a seismic shift in the way the investment industry will fund company research. MiFID II is “expected to have a worldwide impact on the industry and lead to a dramatic drop in the amount of research consumed, with small cap coverage potentially the hardest hit.”<sup>2</sup> Specifically, the regulation will require buy side investment firms to make explicit payments for investment research in order to demonstrate that they are not being induced to trade. McKinsey & Company predicted in a June 2017 report, “The buy side will pay broker-dealers for actionable research that adds investment value, but the demand will fall far short of the mountains of research that banks currently supply ‘for free.’”<sup>4</sup>

*Buy side firms previously receiving duplicitous, and/or low quality research, will become more particular about what they are receiving and who they are receiving it from as they will be explicitly paying for it in order to demonstrate they are not being induced.<sup>3</sup>*

“The buy side will pay broker-dealers for actionable research that adds investment value, but the demand will fall far short of the mountains of research that banks currently supply ‘for free.’”<sup>4</sup>

Demand for high-quality independent research will continue, but research of substandard quality will almost certainly be cast aside as asset managers become more selective in their approach to research spending. Without direct revenue from the sale of such reports or the inducement of trading revenue, producing research will no longer present a viable strategy for many current sell side providers. “The coming transformation of research will force many firms to scale back their broad coverage to a few areas of true expertise, bringing big cuts to research teams in the coming three to four years.”<sup>4</sup> Research departments will shrink, coverage will be dropped, and market visibility into a broad universe of companies will be severely limited.

## The Importance of Research Coverage

*A lack of independent analyst coverage has several adverse effects, both for individual companies and for the capital markets as a whole:*

- *companies with no independent analyst coverage have a reduced market capitalization in comparison with companies that do have such coverage, and are subject to higher financing costs when compared with their*

- *analyst-covered peers;*
- *a lack of coverage by independent analysts limits shareholders' and prospective shareholders' ability to obtain an informed outsider's perspective on identifying strengths and weaknesses and areas for improvement;*
- *because analyst reports trigger the buying and selling of shares, the lack of such reports frustrates the formation of a robust trading market*

*-Final Report of the Advisory Committee on Smaller Public Companies; April 2006<sup>1</sup>*

Global Value Research Company (GVRC), a division of Global Value Investment Corp., is a full-service investment research provider. GVRC believes that market pricing is inherently inefficient, especially in the case of smaller companies that lack the benefit of robust research coverage or a large investor relations department. In order to fill the gap GVRC often observes between the market price of a company's shares and the intrinsic value of the enterprise, GVRC offers issuer-sponsored research services. Such services are commonplace in debt markets, where companies compensate ratings firms such as Standard & Poor's, Moody's, and Fitch to provide high-quality, objective, and independent ratings based on a thorough analysis of their businesses. GVRC provisions equity research services in a comparable manner, striving to convert complex issues and events into actionable ideas that are distributed to a large research audience, some members of which may not have the time or resources to adequately perform research.

The dissemination of accurate and robust company analysis to investors is of paramount importance to any company as it builds and maintains an informed shareholder base. GVRC believes that a healthy shareholder base consists of both institutional and retail investors. Passive investment vehicles, while an increasingly common source of capital, should be welcomed with caution: capital is often allocated algorithmically, flowing out as easily as it flowed in. Furthermore, many passive investment managers defer to proxy advisory firms Institutional Shareholder Services and Glass Lewis for matters put to a shareholder vote. Disproportionate passive ownership can expose a company to the decisions of these entities, which GVRC has, on more than one occasion, found to be ill-informed or incorrect. Knowledgeable and actively-engaged investors are much more apt to consider all available information before casting votes.

GVRC strives to work with its corporate clients to inform current investors and attract new investors by offering independent and credible research reports to help companies clearly communicate their stories.

## **Important Considerations**

*What are GVRC's capabilities?*

GVRC employs five research analysts: three associates based in the United States and two associates based in Hyderabad, India. This geographical dispersion provides the firm with nearly-24-hour coverage, allowing us to quickly identify news events that might affect our analysis of a subject company and digest such events into our thinking around the clock. Additionally, our geographic and cultural diversity fosters critical thinking shaped by multiple worldviews.

Our coverage universe is concentrated, typically consisting of fewer than 20 companies. As such, we are able to commit more time to the thoughtful analysis and comprehensive understanding of each of these companies than many of our peers. We diligently dissect financial statements, frequently speak to other shareholders, and regularly interact with company senior management. We closely follow the competitors of subject companies and the industries in which they operate. We consider ourselves among the most informed followers of the companies about which we produce research.

Finally, we have cultivated relationships with other institutional asset managers, research firms, investor relations contacts, and individuals. We are adept at communicating our investment thesis and the academic underpinnings of actionable ideas. While we are not an investor relations firm and do not organize investor conferences, we are able and willing to take inbound calls from interested investors and discuss our research reports at length. If appropriate, we can facilitate an introduction to an investor relations contact or senior management.

*How does GVRC manage the conflict of interest arising from its equity ownership?*

We objectively and academically evaluate each subject company to arrive at a definitive intrinsic value and a defenda-

## GVRC Research Differentiators

### *Parent Company Holds Equity Positions in Covered Companies*

The asset management subsidiaries of GVRC's parent company, Global Value Investment Corp., own securities of companies that are the subjects of our research reports in the managed portfolios of retail, institutional, and accredited investors. Our research associates generally own securities of subject companies in their personal portfolios. As a condition of our ownership, we conduct thorough due-diligence on companies, understanding them through a different lens than many sell-side analysts. We believe that such equity ownership is the surest way to focus our attention.

### *Research is Widely Distributed and Available to All Classes of Investors*

Most sell side research is distributed to a certain audience - paying customers. Even when published on investment research platforms, sell side research is often behind a paywall, available only to clients of the firm publishing the research. Our research client is the subject company, not any firm or individual. Funding for our research is derived solely from fees paid by the sponsoring company; we do not seek fees from any other individual or entity. Therefore, research is distributed to any interested investor free of charge. All investor classes, from retail investors to sophisticated institutions, have immediate and simultaneous access to our research.

### *Reports Do Not Include Quarterly Estimates*

We believe quarterly revenue and earnings estimates are often inaccurate, and create a short-term focus on inherently uncertain earnings. Furthermore, "short-termism" distracts management from focusing on the long-term growth and success of the business. Our research reports are geared towards patient, long-term investors, not speculative, short-term traders. If a subject company provides earnings guidance, we will evaluate and comment on the validity of such guidance, but will not use it as a basis for forecasting earnings.

ble investment thesis. Our research reports contain both a qualitative commentary about the business, industry, and competition as well as a quantitative analysis of the company's financial condition and a valuation. Arguably, a conflict of interest exists in any research relationship; sell side research firms have been motivated to maintain a favorable research relationship with a company by the potential of lucrative investment banking fees.

Pursuant to Section 17(b) of the Securities Act of 1933, we fully disclose the nature of our relationship with the subject of each research report. Additionally, internal controls have been adopted to prevent inappropriate trading in the securities of a subject company. We take great care to maintain our reputation of thoroughness and objectivity.

### *How is a sponsored research services agreement structured?*

In accordance with FINRA guidelines, the initial term of a sponsored research services agreement is one year. Upon initiation of coverage, GVRC will produce an initiation report that summarizes the subject company's operations, describes the business, discusses its financial statements, analyzes its overall financial condition, elaborates on relevant financial considerations, reviews management and corporate governance, lists large shareholders, explores the company's industry and its competitive positioning, details the mathematical calculation of intrinsic value, and lists risks, catalysts, and expectations for the investment.

Each quarter, we will provide a timely and thorough update report that summarizes recent developments, discusses the subject company's financial statements, analyzes its overall financial condition, elaborates on relevant financial considerations, reassesses management, updates the list of large shareholders, reexplores the company's competitive positioning, details the updated mathematical calculation of intrinsic value, and discusses changes to risks, catalysts, and expectations for the investment. These quarterly update reports are released after the subject company's 10-K, 10-Q, or equivalent document is filed, a quarterly investor conference call has occurred (if applicable), and we have held a follow-up call with company management.

We will issue, at our discretion, interim research notes briefly detailing material developments or relevant information, such as a site visit or meeting with senior management.

All research reports are submitted to the subject company for factual verification prior to publication. It is our goal to completely and accurately convey to the market all relevant information about the company's current state and strategic direction. To this end, we strive to work with subject companies as closely as possible to ensure no relevant fact is overlooked. However, we cannot release valuation or rating information ahead of publication, so certain parts of each report will be redacted until that time.

### *What can GVRC add to a company's existing research coverage?*

Investors, institutional and retail alike, employ a range of different investment philosophies. This is perhaps most evident when considering the investment community's fixation on asset allocation and asset class diversification. While a subject company's target investor is not solely defined by factors such as its market capitalization or dividend yield, investment managers often screen possible investments based on such quantitative factors. GVRC's research appeals to long-term, value-oriented, fundamental investors. Our analysis provides a comprehensive basis for investment and is far more detailed than reports produced by many of our peers.

The current existence of sell side research coverage for a particular company does not in itself ensure coverage in the future. Given the increasing selectivity of investment managers in purchasing research, and the limited investment banking revenue sought after by a crowded field of firms, coverage could be dropped at any time.

## **Distribution**

GVRC's research is available to asset managers, financial advisors, individual investors, and any other interested party. Research reports and notes are distributed via the following channels:

- FactSet Research Systems, S&P Capital IQ, and Thompson Reuters investment research platforms. Reports are available to all subscribers to these services.
- Our website, which can be accessed by the investing public.
- Approximately 1,500 registered investment advisory firms, which include hedge funds, financial advisors, and boutique asset managers. We have screened each of these contacts to ensure that they invest in individual equity securities.
- A customized universe of mutual funds. We categorize mutual funds by market capitalization and investment style focus, as well as by industry/sector focus or other relevant classification. We work with subject companies to define their target mutual fund investor and build a customized distribution list.
- Existing investors in the subject company, which we identify from public records and private conversations.
- Potential shareholders, or firms with which we maintain professional relationships and regularly exchange ideas based on our shared investment philosophy.

## **Conclusion**

As traditional buy side firms become more selective about the research they purchase, sell side research providers will come under increasing cost pressure, resulting in the downsizing of research departments and termination of coverage for companies outside of their core competencies.

GVRC strives to thoughtfully evaluate a company's intrinsic value and provide both qualitative and quantitative commentary on subject companies. The wide dissemination of this information generates investor interest, influencing the formation of a market in the subject company's securities and driving share price. Knowledgeable and patient investors both aid in closing the gap between market price and intrinsic value, and provide a stable platform on which a company can grow.

<sup>1</sup>U.S. Securities and Exchange Commission, Advisory Committee on Smaller Public Companies. (2006, April 23). *Final Report of the Advisory Committee on Smaller Public Companies to the United States Securities and Exchange Commission*. Retrieved from <https://www.sec.gov/info/smallbus/acspc/acspc-finalreport.pdf>

<sup>2</sup>Mellor, B., Dey, E. & Maranz, F. (2017, July 27). Analysts Hope Companies Will Pay for Research About Themselves. *Bloomberg*. Retrieved from <http://www.bloomberg.com>

<sup>3</sup>Pricewaterhouse Coopers LLP. (2016, September). *The Future of Research*. Retrieved from <https://www.pwc.com/gx/en/advisory-services/publications/assets/the-future-of-research-mifid-ii.pdf>

<sup>4</sup>McKinsey & Company, McKinsey Working Papers of Corporate & Investment Banking. (2017, June). *Reinventing Equity Research As a Profit-Making Business*. Retrieved from [https://www.ecrresearch.com/sites/default/files/public/article/McKinsey\\_CIB\\_WP13\\_Reinventing%20Equity%20Research\\_2017.pdf](https://www.ecrresearch.com/sites/default/files/public/article/McKinsey_CIB_WP13_Reinventing%20Equity%20Research_2017.pdf)

## About Global Value Research Company

Global Value Research Company is the investment research division of Global Value Investment Corp, a research and advisory firm serving individual and institutional clients. Founded in 2007 in Milwaukee, Wisconsin, the firm currently operates additional offices in Boston, Massachusetts; Charleston, South Carolina; and Hyderabad, India. Global Value Research Company espouses the value investing principles pioneered by Ben Graham and David Dodd, providing comprehensive fundamental analysis of publicly traded companies around the world. Our research process focuses on diligently examining company financial statements, understanding competitive positioning, assessing industry and macro-economic trends and speaking with company senior management on an ongoing basis. Further information about Global Value Research Company's services can be obtained by contacting the firm directly.

### Disclosures

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