

Independent Equity Research: The New Frontier of Equity Research



Roopa Kudva
Managing Director & CEO
CRISIL Ltd.

A pioneering initiative in the Indian equity market, CRISIL Independent Equity Research (IER) offers an independent and unbiased assessment of a company's fundamentals and valuation. It extends the concept of Initial Public Offering (IPO) grading to equities that are already listed. In contrast with traditional equity research models, IER is carried out by an entity that

does not have a transactional interest in the stock that is being researched. CRISIL IER also differs from conventional research in not making 'buy', 'hold', or 'sell' recommendations, and instead offers an opinion on the company's fundamentals and valuation. The advent of IER makes for a new paradigm in the Indian equity market, empowering individual investors to make better-informed investment decisions backed by high-quality research from India's leading research house.

Beyond conventional models

There are two types of conventional equity research: sell-side and buy-side. A sell-side analyst works for a brokerage that manages individual accounts and provides reports with recommendations to the clients of the firm. The reports usually contain 'buy', 'hold', or 'sell' recommendations on individual stocks. The brokerage firm gets a commission on the transactions when a client decides to trade stock. Though sell-side reports are available to investors, the recommendations may be inappropriate for certain investor classes and their investment strategies.

A buy-side analyst usually works for an investment fund or asset management company. These analysts research and make recommendations to the managers of the funds that employ them. Buy-side analysts attempt to determine the attractiveness of investments, and how well these fit with the funds' investment strategies. The recommendations, made exclusively for the benefit of the funds that pay for them, are not available to anyone outside the fund. The advantage is that buy-side research does not hinge on transactions for revenues, thus avoiding the conflict inherent to sell-side research. The disadvantage is that buy-side research is not accessible to the average investor, limiting its use to the investor class as a whole.

IER evolved from the need to overcome the drawbacks of conventional research. IER is conducted by independent entities excluding stock broking firms or similar financial market participants. An independent perspective from an entity that does not have a transactional interest can be used by both retail and institutional investors to arrive at their own investment decisions. IER by a competent agency provides a unique value proposition: the research has both credibility and accessibility, is free from the inherent conflicts in sell-side research, and avoids the limitations of buy-side research. It makes top-quality research accessible to the average retail investor.

The retail investor – a knowledge gap

In India, the exchange-traded equity market has a long history that dates back to the nineteenth century. Bombay Stock Exchange (BSE), established in 1875, is the oldest stock exchange in Asia. However, retail participation in the equity market still has much headroom for growth. The Committee on Investor Awareness and Protection (Swarup Committee) observed in 2009, "Today, there's an army of nearly 3 million financial advisers plus banking staff selling non-banking financial products. They serve about 188 million investors holding financial assets. Of these, 8 million investors participate in debt and equity markets, either directly or indirectly through complex and risk-bearing products like mutual funds and market-linked insurance plans."

Despite improvements in the functioning of the equity market, which now has rolling settlements, dematerialised securities, a proper monitoring and margining system, an active futures and options segment, and a highly effective regulator, most Indian households have not participated in this market. Developing retail participation in the equity market should be given high priority, especially since we already have the critical infrastructure in place. One of the reasons for the low level of retail participation in the equity market is the lack of credible and accessible research. Without proper information, some retail investors are intimidated by the level of volatility in the equity market, and the uncertainty about fundamentals of companies, and thus fail to participate in the Indian growth story. Others invest based on rumours or tips, or follow short-term trends, and often suffer losses as a result. IER can act as a catalyst in increasing retail participation and creating a new generation of informed investors.

Mid-cap and small companies – an awareness gap

Over the years, liquidity in India's stock exchanges has increased substantially. For instance, the average daily turnover in the cash market segment of National Stock

Exchange (NSE) was just Rs.2,078 crore in 2001-02. By 2009-10, the average daily turnover had grown over eight times to Rs.16,959 crore. However, the transactions are mainly concentrated in the large-capitalisation stocks. In 2009-10, the top 100 stocks contributed over 74 per cent of the turnover in the cash segment of NSE. One of the reasons for this is inadequate research coverage; the focus of traditional research is mostly on large-cap stocks. A survey by CRISIL indicated that only 150-200 of the 3,500 active listed companies on Indian exchanges receive adequate coverage. IER can help broaden the universe of coverage. Investors typically find it difficult to uncover, research, and invest in opportunities among small-cap and mid-cap stocks. This causes small-cap and mid-cap stocks to exhibit systematic undervaluation and illiquidity. Due to this lack of liquidity, the impact cost for this class of stocks is generally high, affecting the whole price discovery process. IER will enhance liquidity in these stocks, which will help prevent manipulation in their prices. Similarly, many small and medium businesses do not have the means or opportunities to showcase their companies to investors. The market may not assign fair value to such stocks because it lacks information on management capabilities and corporate governance.

IER – bridging the gaps

IER helps bridge many of these gaps, in the process of aiding well-informed investment decisions. For instance, CRISIL uses a proprietary model, the CRISIL Fundamental and Valuation matrix, to present its opinions. The matrix is based on analysis of a company's fundamentals, such as business prospects, financial performance and outlook, management quality, and corporate governance. The valuation component complements the fundamental analysis by providing a current assessment of the fair value of a company's stock.

In the matrix, CRISIL assigns a fundamental grade that provides overall assessment of the fundamentals of the company, in relation to other equity securities listed in India. Grade 5 indicates excellent fundamentals, while grade 1 indicates poor fundamentals. The grade facilitates easy comparison of fundamentals across size and industry. CRISIL also provides an assessment of the potential intrinsic value of the company's equity stock for an equity investor over a 12-month period, incorporating both tangible and intangible factors. Here again, grade 5 indicates a strong upside from the current market price, while grade 1 indicates a strong downside from the current market price. It should be noted that in the equity market, the gap between intrinsic value and market price can remain, or even widen, for an extended period. Even so, dissemination of information and relevant disclosures are expected to improve the valuation process.

Equally important is what CRISIL IER does not provide. CRISIL publishes no 'buy', 'hold', or 'sell' recommendations as part of its equity research. An

investment decision is the product of several factors: some of these, such as the fundamental soundness of the company, or the pricing of the stock, are specific to the stock, while others, such as sectoral preferences, risk-taking ability, and investment timeframe, are specific to the investor. Therefore, rather than providing a transaction recommendation, CRISIL IER distils the analysis into opinions on the stock fundamentals and valuation, the two crucial external inputs in the investment decision.

A choice of models for optimal coverage

To ensure that the widest possible range of companies benefits from the published research, IER should be made available under a variety of models. A company that wishes to showcase its performance track record to investors should be able to sponsor an IER exercise. The IER exercise, by itself, is a statement by management to current shareholders and prospective investors that they have the confidence in their business model to pay an independent entity to perform a fair, accurate valuation of the company's stock. IER can also be sponsored by stock exchanges; this helps the exchanges to improve market depth and lower the impact cost for illiquid stocks. For example, NSE has asked CRISIL to publish equity research on companies that have limited exposure and liquidity. And, finally, investors should be able to directly approach the agency to research companies that they are interested in knowing more about. Investors can use the agency's proprietary research to supplement or corroborate their own analysis.

The benefits of IER

The principal benefits of IER can broadly be looked at under five heads:

Improved liquidity: Consistent research, published in detailed initiation reports and quarterly updates, increases liquidity and helps the market trade the company's stock closer to its intrinsic value

Easy access to capital: IER generates awareness among investors and positions the company as a long-term player during fund-raising programmes

Enhanced visibility: IER positions the company to domestic and international investors in both the retail and institutional segments

Eased bandwidth: IER reports ease pressure on the company's top management and investor relations team's time, by creating a base for discussions about the company

Increased transparency: IER creates an investor-friendly image for the company, and raises transparency levels

CRISIL's experience with IER indicates that consistent research and regular updates increase liquidity in stocks, thus driving the process of price discovery. As a result, access to capital for companies covered by research improves. When a company undertakes a fund-raising program, IER reports with their focus on fundamentals

and business prospects will create awareness in the domestic and global investor community and position the company as a long-term prospect. Thus, the company gets enhanced visibility among both the retail and institutional investors.

A company that undergoes a CRISIL IER exercise receives a detailed assessment from an equity perspective on four pillars — business, financials, management, and corporate governance. This will enable the company to adopt best practices and enhance its positioning with stock market players.

Market response

Investors have responded enthusiastically to IER, by regularly downloading reports, even for larger large companies that are well covered by existing sell-side

research. Besides being available on the CRISIL website, research reports on NSE-sponsored companies are available on the website of the exchange; this ensures that a wide spectrum of investors have access to the reports through NSE as well. Companies that sponsor research generally place the reports on their websites, giving investors yet another route for accessing the reports. With time, increasing coverage, and the growing sophistication of a wider range of small investors, IER has the potential to transform equity investing in India into a more fundamentals-driven and better-informed activity than it has been so far.
