Stockdale

4 January 2016

It's stockbroking but not as we know it

We deal in stock and a dale forms solid ground between two hills – in our case investors and companies

In 2015 we fundamentally altered the structure and approach of our business in response to cumulative and long-running changes in the environment in which we operate. To mark this change, we are today renaming our business from Westhouse Securities to Stockdale Securities.

The broking landscape

Regulatory and market pressures have undermined the traditional UK broking model where recurring income (secondary commissions, normal trading profits and corporate retainers) broadly cover fixed costs, and deal fees put the icing on the cake. Since the Global Financial Crisis (GFC) secondary commissions in particular have been under intense pressure, especially for small-cap brokers. It seems likely that the AIM commission pot has shrunk by c.75% from its 2007 peak. There has been consolidation and failure, but in a capital-light industry with low barriers to entry capacity remains stubbornly high.

Regulatory forces

Capacity pressures have been compounded by a wave of regulatory forces and technological developments in trading. MiFID II, whenever it comes in and whatever its exact details, is just another step in a long, inexorable march of greater regulatory scrutiny which started with the Myners Report in 2001. UK brokers have already witnessed a steady but clear structural shift in the composition of their revenues from secondary to primary. However, there is clearly some further adjustment to come, the degree and timing of which will depend in part on the final MiFID II detailed implementation rules. A further implication of MiFID II is that brokers will not be able to give meaningful research away for free because the 'inducement to trade' runs counter to the principle of best execution. In our view this is unworkable.

Our response

While many of these pressures have been self-evident for some time, most broking businesses seem unable to face up to this harsh new reality and structure themselves accordingly. By contrast, we at Stockdale have grabbed the proverbial bull by the horns. While we remain a 'full-service broker' - we make markets, deal with and give a sales service to over 400 institutional clients, research companies as well as providing corporate broking and finance advice both as Nomad on AIM and a Full Sponsor on the main market – all these services are now unashamedly dedicated to a corporate agenda: *an absolute focus on winning and retaining good quality corporate clients and executing their transactions*.

In adopting this corporate model we are acutely aware of the need to maintain our integrity and the trust of our institutional clients, the key to which is having a long-term, relationship-led, rather than transaction-driven, approach. Without the continuing trust of our institutional clients we have no business. While we remain a work in progress, and will continue to adapt to a changing world, the early signs are that the new model is working both for our clients and for us – we are growing again, winning business, getting deals done and making money.

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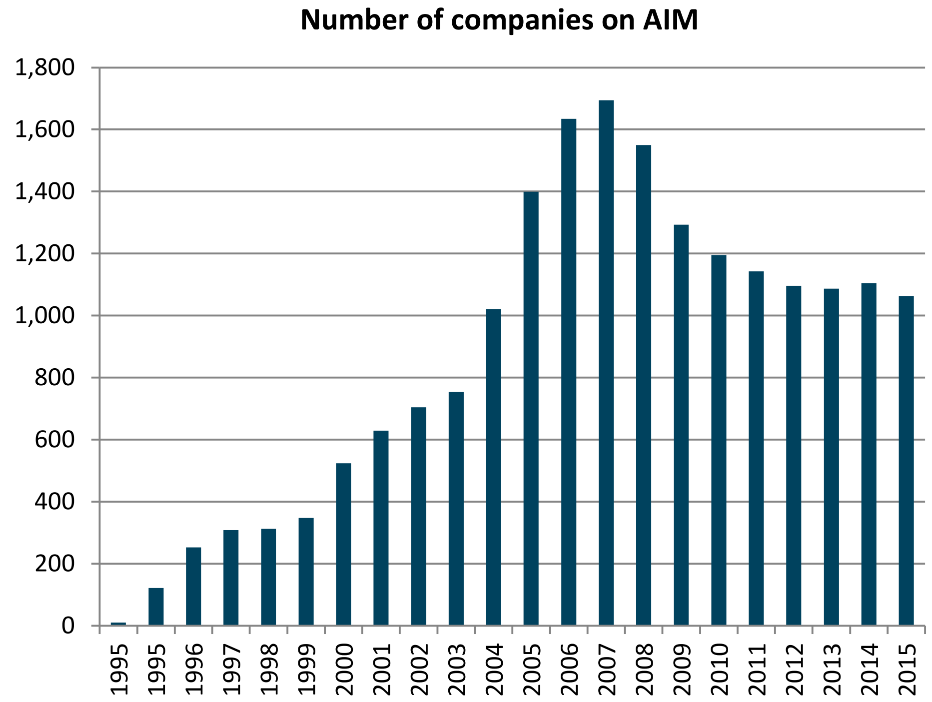
The broking landscape

The traditional UK broking model is broken

Regulatory and market pressures have undermined the ‘traditional’ UK broking model where ‘recurring’ income (secondary commissions, normal trading profits and corporate retainers) broadly cover fixed costs, and deal fees put the icing on the cake.

Since the GFC, secondary commissions in particular have been under intense pressure, especially for small-cap brokers. Between 2003 and 2007 the number of companies listed on AIM more than doubled to 1,694 and the value of trading turnover went up more than 10-fold. Since then, the number of companies has steadily declined to c1000 and turnover has more than halved (charts below and overleaf).



Source: LSE AIM Market Statistics

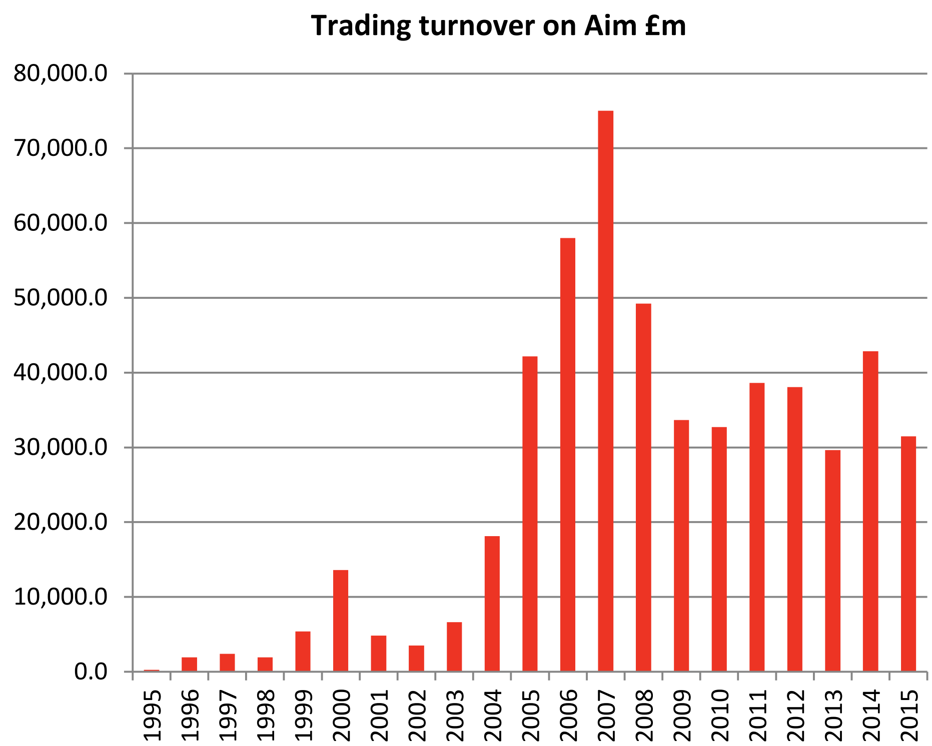
The AIM commission pot has shrunk by c75%

On the basis that commission rates have also halved over that period, it seems likely that the AIM commission pot has shrunk by c75% in aggregate. The main market has fared only slightly better. Technological developments in trading in the form of the advent of electronic and algorithmic trading have further compounded margin pressures for conventional brokers.

Moreover, the Noughties boom led to an influx of stockbroking capacity. There has been consolidation and failure but in a capital-light industry with low barriers to entry, capacity remains stubbornly high. There are still 35 active Nomads.

Capacity pressures have been compounded by a wave of regulatory forces. MiFID II is just another step in a process of greater regulatory scrutiny (quite rightly in terms of improved transparency and more rigour in commission allocation) which started with the Myners Report in 2001. The FSA took up the mantle with a consultation paper (CP176) in 2003 which proposed radical reform that sought to unbundle payment for services from dealing commissions but was persuaded "to work with the grain of an industry-led solution and evolving market practice".

The main development of which has been Commission Sharing Agreements (CSAs) - allocated commission transfers between brokers designed to allow for appropriate payment for services and best execution: if best execution results in Broker A being paid more than their research warrants and Broker B is paid less than their research warrants, Broker A is told to write a cheque to Broker B. Although CSAs have improved the transparency of broker commission allocations, they have clearly not broken the link between trading and paying for research. The FCA has come to the conclusion that this means that CSAs are ultimately incompatible with best execution. This is not a logical position but the FCA's view that CSAs have not been implemented with sufficient rigour to avoid best execution issues probably is a reasonable one. More generally, most people are more careful when spending their own money than when spending other peoples'.



Source: LSE AIM Market Statistics

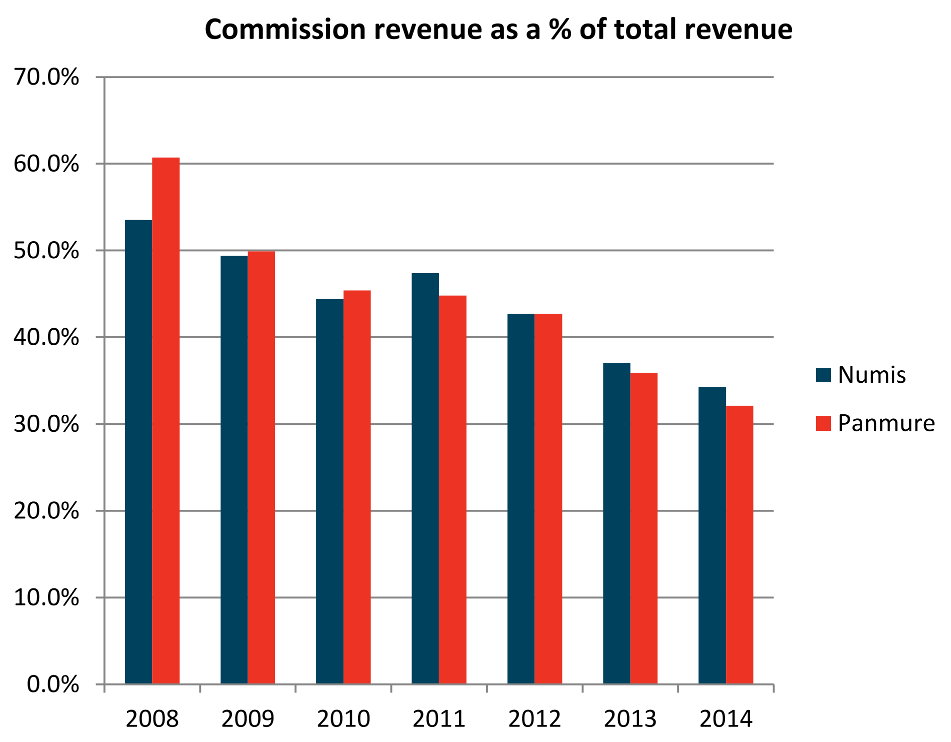
Many forests later the FCA concluded in July 2014 (DP 14/3) that the industry-led approach "was not working" and full unbundling – a complete break between trading and the payment of all broker services other than execution - was required, meaning that if institutional investors wanted to pay for research it had to be out of their own pocket.

The FCA has also argued that this approach is consistent with the underlying principles of MiFID II (transparency and the duty of best execution) which was due to come into effect in January 2017. The European Securities and Markets Authority ("ESMA"), which is charged with the practical implementation of MiFID II, duly agreed although it has since acquiesced to a minor concession of pre-funded (by clients) "research payment accounts" (RPAs). RPAs must be an agreed, direct charge on clients and a link to trading is clearly ruled out (contrary to some interpretations). It seems likely that in practice any RPA charge would have to be offset by a decline in the management charge, at least partly, so the fund manager would effectively end up paying for the research anyway.

MiFID II is just a small final step in an inexorable march

We are still waiting for ESMA's final plan and it seems that the implementation of MiFID II may be pushed back by a year because of technical issues regarding the implementation of transparency rules in the bond market. Recent unofficial but seemingly well-informed reports also suggest that beefed-up CSAs are back on the agenda under "strict conditions". Regardless of the details and the timing (and the FCAs response) these are just further small steps in an inexorable march. Commissions will not fall off a cliff whenever MiFID II comes in to effect because they are already washing around in the shallows. However, there is clearly some further adjustment to come and the degree and timing of this adjustment will depend in part on the final MiFID II detailed implementation rules.

The chart below shows that these pressures are not confined to just the smaller independent brokers. Even for Numis, the leading player in the UK market, there has been a steady but clear structural shift in the composition of its revenues from secondary to primary. In Numis's results for the year-ended September, 2015 the commission ratio fell below 30%. Informal discussions with some of the unquoted players suggest a similar picture across the broking sector.



Source: Stockdale Securities from company accounts; commissions plus trading revenue for Panmure

FCA thinking is based on the doctrine of perfectly efficient markets

Before we turn to how we have restructured our business in response to these pressures it is worth noting the FCA's practical rationalisation of conclusions which are essentially based on the doctrine of perfectly efficient markets:

> *"There is also a concern that if research was reduced on smaller companies, the loss of this information to the market would lower trading activity in those stocks, and this reduction in secondary market liquidity*

may act as a barrier for such businesses to raise further equity. We do not believe a significant drop in research is likely and so this consequence would be unlikely to arise. We would re-iterate that if research supplied by a broker is genuinely of value to the investment manager, we would expect they would continue to obtain both execution and research from the broker under an unbundled regime, albeit on a separate basis and with an explicit, upfront amount being paid for the research."

FCA DP 14/3, July 2014

So essentially if research is of value then it will be paid for, and if it isn't it doesn't matter. The author behind this idea has clearly never been a small-cap stockbroker.

The efficient market hypothesis for the provision of research might possibly work for large caps where fund managers have to know, and have a view on, all the companies in their investable universe. It cannot possibly work for all of the 1,300 smaller companies listed in the UK (main market and AIM) when most small-cap fund managers will not have a view, or even know about, most of them.

Small-cap ideas have to be 'broked' to persuade the fund manager to put in the time and effort to properly assess the situation and research is a key part of the process. Upfront payments don't and can't work when it can feel like an achievement to get a fund manager just to pick up a research note. That does not mean that there is no value in the research. It just means that the provision of research is not a perfectly efficient market.

In economics this is known as an "experience good" – a product where its characteristics, such as quality, are difficult to observe in advance but can be ascertained upon consumption ("Information and Consumer Behavior", Nelson P, Journal of Political Economy, 1970). Like tips in restaurants, up-front payments don't work in this situation.

The idea that there are investors willing to pay up-front for research on all (or even most) of the 1,300 small-cap companies listed in the UK is not credible. Most micro-cap companies (sub-£50m) are now only generally covered by the house broker and perhaps a 'paid-for' (by the company) research business. This largely explains the growth of paid-for research which potentially creates another set of conflicts - an example of the law of unintended consequences and another story. It also means that for these companies there are no meaningful consensus estimates.

Even some £500m or greater market-cap companies struggle to get more than a handful of analysts covering them and by some accounts quality has also fallen (See table and case study in Appendix)

Our Response

While many of these pressures have been self-evident for some time, most broking businesses (with some notable exceptions) seem unable to face up to this harsh new reality and structure themselves accordingly. By contrast, we at Stockdale have grabbed the proverbial bull by the horns. While we remain a 'full-service broker' - we make markets, deal with and give a sales service to over 400 institutional clients, research companies as well as providing corporate broking and finance advice both as Nomad on AIM and a Full Sponsor on the main market – all these services are now unashamedly dedicated to a 'corporate' agenda – *an absolute focus on winning and retaining good quality corporate clients and executing their transactions*. The secondary trading of shares is still a useful by-product of this activity but it is no longer an end in itself.

We have grabbed the proverbial bull by the horns

In adopting this corporate model we are acutely aware of the need to maintain our integrity and the trust of our institutional clients – the key to which is to have a long-term, relationship-led, rather than transaction-driven, approach. Without the continuing trust of our institutional clients we have no business. That doesn't mean that we will always get things right of course.

However, we no longer undertake activities that do not contribute to the corporate agenda. Hence, while research remains a key component of our integrated offering and a vital part of our IP, as a general rule our analysts now only cover 'house' stocks or targets. They will of course keep a watching brief on our corporate clients' key competitors to remain the authoritative voice in the market on their stocks. Similarly, we only make markets in house stocks and our sales people are expected to know our corporate clients as well as the analyst, albeit from a different perspective.

We have gone from a 2:1 model to a 1:1 model

A simple way to see how this change in priorities has been reflected in the structure of our business is that, in the traditional model, for every head on the corporate side of the Chinese Wall there were two heads on the trading floor (a 2:1 model). This is still the way most full-service broking businesses are structured, reflecting the pre-GFC composition of revenues. In our business, even though we can still perform all the functions we did before for, for every head in the Corporate Department there is one head on the trading floor (a 1:1 model) which more closely reflects the composition of our revenues.

The main exception to this corporate model is our Investment Funds (closed-end listed funds) business where both the composition of our revenues and the team and its activities still more closely resemble the conventional broking model and continue to be successful on that basis.

A strict interpretation of MiFID II, again adopted by both the FCA and ESMA, throws up a further obstacle for the broking industry which is that if fund managers don't want to pay for research they will not be able to receive it for free. This follows from research being seen as an "inducement to trade" (even if, it seems, no one is willing to pay for it) and therefore a potential conflict with best execution. The implication is that a regulated business will have to stop sending research to fund management clients unless it is not operating as a brokerage ie dealing on behalf of the clients. This does not seem workable and is potentially extremely damaging to the economy given the importance of SMEs to economic growth.

Things that are not workable tend to find 'work-arounds'. The recent reports referred to earlier also suggest that "non-substantive material" on short-term commentary on company results will not count as an inducement. That doesn't sound like meaningful research but it may provide a fig leaf. It may be that a third-party 'firewall' will be used to distribute research. It may be that institutions will be willing to pay a material but nominal amount to receive research from smaller brokers and that this will be deemed to satisfy the requirements of MiFID II.

Smaller brokers have also been granted regulatory exemption before, for example on European rules on bonuses (although this turned out to be largely academic of course). In any event if we can't find a way to distribute our research as far and wide as possible to promote our clients in the right way, we won't have a business (and in the case of our client Advanced Oncotherapy the UK wouldn't be having its first proton cancer therapy facility). What we can't do is stop trading in our clients' stock. If we do that we can't serve them properly.

In any event, what we do only works well when all areas of the firm work together to provide a fully integrated and coherent service, which is tailored to the needs of our corporate clients, in a way that also helps their shareholders – our institutional clients – make money. This has always been the case, but the focus of our business is now very different and, while generally being sceptical about name changes, on balance we thought that a change was appropriate under the circumstances.

The story of Admiral James Stockdale is worth looking up

Why Stockdale? Hopefully it's easily remembered with the right number of syllables, made up of 'stock', which we trade, and like 'dale' is an old English word. Corporate broking is unique to London, quintessentially English and when done well is about relationships rather than transactions: taking the long view, not acting expediently; about teamwork not individuals and above all, acting with integrity.

A dale also forms solid ground between two hills, just as we at Stockdale connect investors and companies. There was also an inspirational leader called Admiral James Stockdale whom we admire and is worth looking up if you don't know the story.

Finally, we want our clients to know that alongside the strategic repositioning of our business there has also been a financial restructuring. This has been necessary because of the historic poor financial performance of the business and in order to incentivise new management and staff with a firm-wide profit sharing and equity incentive scheme. This aligns the interests of all our stakeholders and incentivises all Stockdale employees to share our culture of working together to deliver for our clients, both corporate and institutional.

Fortunately, while we remain a work in progress, and will continue to adapt to a changing world, the early signs are that the new model is working both for our clients and for us – we are growing again, winning business, getting deals done and making money.

Appendix: £400-600m Market Cap Company Coverage

Company	Market Cap £m	Number of House Brokers	Number of Analysts
Premier Oil plc	569.6	2	26
Soco International plc	453.9	2	15
Spirent Communications plc	493.9	2	14
Oxford Instruments plc	505.6	1	13
SThree plc	469.1	2	12
Consort Medical Plc	460.3	1	11
Devro plc	499.5	1	10
Seplat Petroleum Development Co.Ltd.	460.6	2	10
Enterprise Inns Plc	598.6	2	9
888 Holdings Plc	573.3	1	9
Novae Group plc	538.9	2	9
RPS Group Plc	512.3	2	9
Hill & Smith Holdings PLC	567.9	1	8
Cambian Group Plc	535.6	2	8
Tyman Plc	516.1	1	8
NCC Group plc	564.1	2	7
Breedon Aggregates Limited	561.9	2	7
e2v technologies plc	525.4	1	7
AO World Plc	509.5	3	7
Ricardo plc	485.6	1	7
Green Dragon Gas Ltd.	455.3	3	7
EMIS Group plc	584.0	1	6
Secure Trust Bank Plc	525.7	2	6
KCOM	479.2	2	6
James Fisher & Sons plc	554.2	2	5
Helical Bar plc	540.1	2	5
De La Rue plc	498.6	2	5
Primary Health Properties PLC	458.5	2	5
Mulberry Group plc	546.0	1	4
Fevertree Drinks Plc	540.5	1	4
Nichols plc	518.1	1	4
Capital & Regional plc	488.8	2	4
Young & Co.'s Brewery	590.6	1	3
Quindell Plc	480.6	1	2
Plus500 Ltd.	446.3	1	2
FDM Group (Holdings) Plc	539.7	1	1

Appendix: Case Study of a well-established c£500m market cap company

Verbatim Comments from the Finance Director:

"We have fewer analysts now than ever following us. I would also say it is not just quantity. The quality is now particularly poor. Our 2 House Brokers follow us because they have to - the others are a mixed bag and none of them enthusiastic. Notably:

- House broker
- House broker
- Investec
- Arden
- Jefferies
- Cannaccord
- Numis
- Cenkos

I looked back at my files. The conclusion I came to is that 2009 was a peak for us. Notably in 2009 we had 13 and a large number of those were very attentive:

- Collins Stewart
- Investec
- Panmure
- Brewins
- Arbuthnot
- KBC Peel Hunt
- Altium
- Numis
- Liberum
- Noble
- Arden
- RBS
- Charles Stanley"

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