

# Extra-financial research: Business as usual or the dawn of a new era?

*Summary of a baseline evaluation  
of leading sell-side research institutions*

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# Extra-financial research: Business as usual or the dawn of a new era?

*Summary of a baseline evaluation  
of leading sell-side research institutions*

This summary is based on a study by onValues Ltd.  
(Authors: Ivo Knoepfel and Regula Ritter) commissioned by:

Enhanced Analytics Initiative and  
Mistra Foundation for Strategic Environmental Research

# ENHANCED ANALYTICS INITIATIVE

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## Frequently used abbreviations

EAI: Enhanced Analytics Initiative  
EFI: Extra-financial Issue(s)

## Disclaimer

The report is intended to be for information purposes only and it is not intended as a promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The report is not intended to provide, and should not be relied on, for accounting legal or tax advice, investment recommendations or advice about suitability of organisations as service providers. Whilst based on information believed to be reliable, no guarantee can be given that it is accurate or complete.

## Executive Summary

This report includes results of a baseline evaluation of brokerage research prepared on behalf of the member institutions of the Enhanced Analytics Initiative (EAI). Based on these results, EAI members will allocate a minimum of 5% of their respective brokerage commission budgets for the first half-year of 2005 to sell-side research houses who are effective at analysing material extra-financial issues and intangibles.

The evaluation included an assessment of past research output released between January 2003 and November 2004 and an assessment of future research commitments for 2005, as indicated by brokers in their replies to a call by EAI members.

From the initial universe of 21 brokers which have responded to EAI's call, and based on the detailed evaluation undertaken, EAI has decided to commend the seven highest ranked brokers, in terms of both their quality and coverage of past research output and of their commitments for 2005. These are, in alphabetical order: Deutsche Bank, DrKW, Goldman Sachs, HSBC, Morgan Stanley, UBS, and WestLB. EAI members reserve the right to reward also the three next ranked institutions (Runners-up), which are, in alphabetical order: ABN Amro, Citigroup and CM-CIC.

It should be noted that at each of the planned half-yearly ongoing evaluations, all brokers will be considered as eligible for being included in this top category. Performance of a previous evaluation will not determine whether a broker is included or not in future evaluations.

The response to the EAI call has been very encouraging. Of the 31 brokers contacted, 21 have confirmed their commitment to the initiative, which results in a feedback rate of 68%. The analysis of past research output and future commitments shows that several brokerage institutions are currently "shifting gear" from a rather opportunistic attitude to showing clearer and stronger institutional commitment towards research on extra-financial issues and intangibles.

In the past, the ad-hoc, client driven approach taken by many brokers has resulted in a rather "patchy" coverage of different extra-financial issues, sectors and companies. EAI is convinced that, by providing the right incentives, it can support brokers in taking a more systematic approach to this type of research. In their commitments for 2005, some brokers have already announced that they will be providing global or European coverage of sectors for selected extra-financial issues.

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EAI is confident that the quality and coverage of extra-financial issues will improve considerably in the near future but acknowledges that this depends on additional clients sending a clear signal that this is what is wanted. In particular, the presence of a U.S. asset owner would have a significant impact on global brokers.

Based on the encouraging response to its call and on the observed developments in the sell-side research field, the EAI would like to encourage brokers:

- To cover the effect of changing regulatory frameworks well ahead of their implementation, before the information has been integrated in the market's price building mechanism
- Not to shy away from issues which are difficult to quantify, such as long-term risks or impacts on intangible value (e.g. brands, company reputation) or sensitive to comment on (e.g. CEO remuneration, M&As)
- To differentiate more clearly between different time-horizons of causes and effects. Long-term trends, such as changing demographics or increasing environmental pressures, for example, can have short-, mid- and long-term effects on company value. It is therefore important to distinguish and declare different time-horizons used in research.
- To research new issues and develop innovative methodological approaches, thereby taking a lead in further developing the extra-financial research agenda.
- To take a lead in developing better frameworks to integrate extra-financial research in company and stock analysis, thereby enhancing the value of research for better investment decisions.

## 1. Introduction

This report presents the main results of a baseline evaluation of brokerage research prepared by onValues Ltd. on behalf of the founding member institutions of the Enhanced Analytics Initiative (including AGF, BNP Paribas, DBI, DIT, Generation Investment Management, Mistra, PGGM, RCM, and the Universities Superannuation Scheme).

The Enhanced Analytics Initiative (EAI) comprises a group of institutional investors and fund managers who have decided to allocate individually a minimum of 5% of their respective brokerage commission to sell-side research houses (or others) who are effective at analysing material extra-financial issues and intangibles. The EAI gives brokers a commercial incentive to produce innovative and differentiated research. Total commissions for this project, at 5% of the total spent by current consortium members, are currently in the order of € 4-5 million for 2005.

This summary highlights the most important trends and developments observed in the brokerage research field and presents the group of best brokers identified during the baseline evaluation. These brokers will be eligible for commissions allocation by EAI members for the first half-year of 2005. In future, EAI will commission six-monthly ongoing evaluations, whose main focus will be on the research output of the preceding six months.

The baseline evaluation included two distinct parts:

- An assessment of past research output released between January 2003 and November 2004.
- An assessment of future research commitments for 2005, as indicated by brokers in their replies to a call by EAI members.

The universe of brokers assessed in terms of past research output includes 10 European, 6 North-American and one Japanese broker. 60 individual research products (reports, notes, briefs) were included in the analysis on the basis that EAI's Steering Group members knew of this work and thought it relevant. An initial screening analysis led to the selection of a group of top 10 brokers which were analysed in detail. A systematic, criteria-based process was used throughout the evaluation.

The assessment of the brokers' commitment to produce relevant research in 2005 is based on the analysis of the EAI Reply Forms sent in by brokers. A total of 21 brokers, out of the 31 contacted, responded to EAI's call by returning the EAI Reply Form. The resulting feedback rate of 68% is, in the eyes of EAI, a sign of the strong interest by the brokerage community to respond to the call for better extra-financial

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research. Through the form, EAI asked brokers to confirm their interest in participating in the EAI initiative and to declare planned research outputs for 2005, including the responsible analyst(s), the form and date of delivery. The Reply Form also includes three questions aimed at assessing the quality of the research planning process, of the research organisation and of major investments planned for 2005 (new hires, major process upgrades etc.).

### 2. Main trends observed

The analysis of both past research output and future commitments shows that many brokers are still taking a cautious and rather opportunistic approach towards EFI research. This being said, several brokers are currently “shifting gear” from an opportunistic attitude to showing clearer and stronger institutional commitment. EAI’s goal is to support this trend.

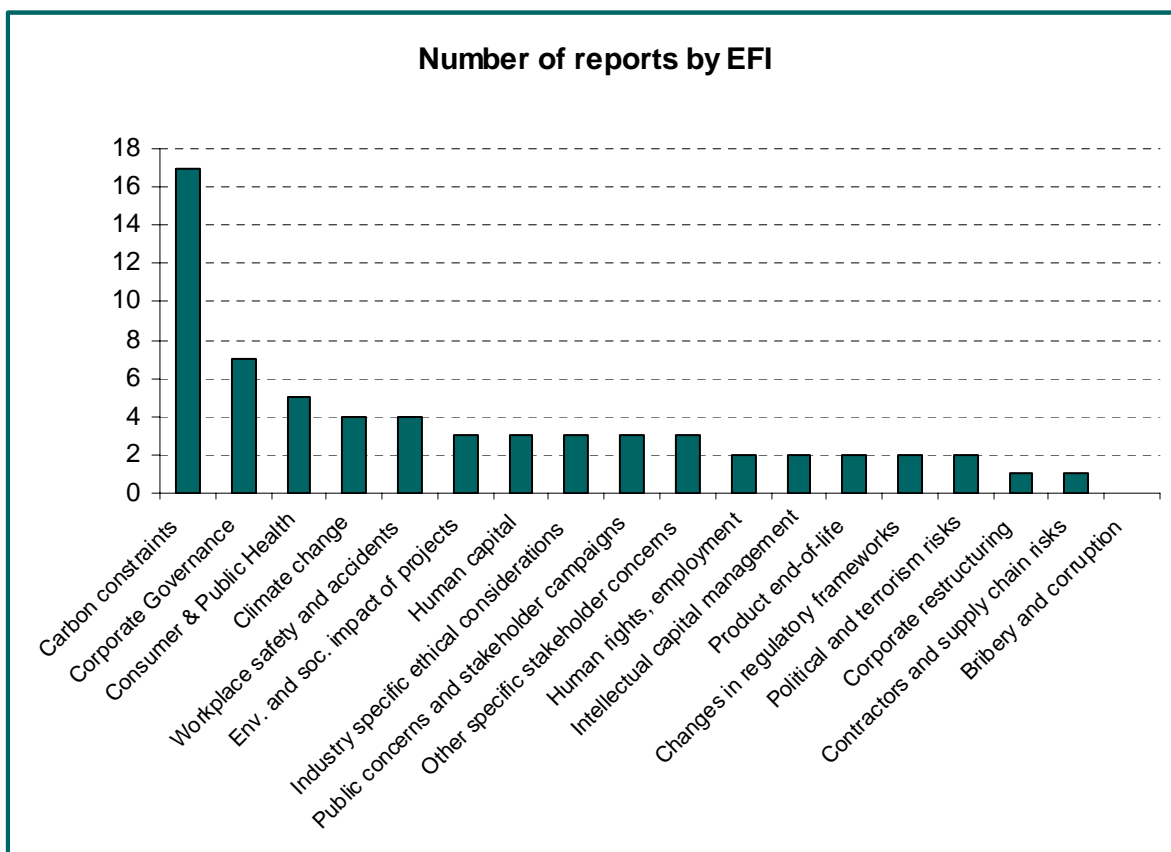
EAI has mapped brokers against five distinct phases of institutional commitment towards EFI research:

1. Ad-hoc, client driven (4 brokers):  
The broker is reactive and will look at EFIs only if important clients ask for this work to be done.
2. Ad-hoc plus in-house champions (5 brokers):  
The research is still mainly client driven and therefore of an ad-hoc/patchy character. At the same time, though, in-house champions appear, contributing an increased level of continuity and in-house thinking.
3. Low-hanging fruits (1 broker; 4 brokers transiting from phase 3 to 4):  
The broker acknowledges, at an institutional level, that coverage of EFIs offers some interesting business opportunities. But the research is done in a rather opportunistic way, focusing on low-hanging fruits, i.e. covering well accepted topics that require a low amount of investment.
4. Institutional commitment (3 brokers)  
Here, the institution starts acknowledging EFIs as being of strategic importance, at least in some key sectors. The broker considers extra-financial research as a differentiator and as an important business opportunity, and commits sizeable investments to improve its coverage of selected sectors and issues.
5. Core business strategy  
The institution puts extra-financial research at the core of its business strategy. This is reflected in a high level of investment and quality research output. Research on EFIs is fully integrated in financial analysis.

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The ad-hoc, client driven approach taken by many brokers in the past years has resulted in a rather “patchy” coverage of different EFIs, sectors and companies and our assessment is that without an initiative like EAI, this situation could well have continued. Very rarely have brokers provided investors and the buy-side with proper “investable universes” in this field. In their commitments for 2005, though, some brokers have announced that they will be providing global coverage of sectors for selected EFIs, or European coverage for a broader range of EFIs.

Concerning the coverage of different extra-financial issues, EAI has observed that certain issues are better researched than others. This can be seen in the next graph showing the allocation of the 60 reports assessed to different EFIs:



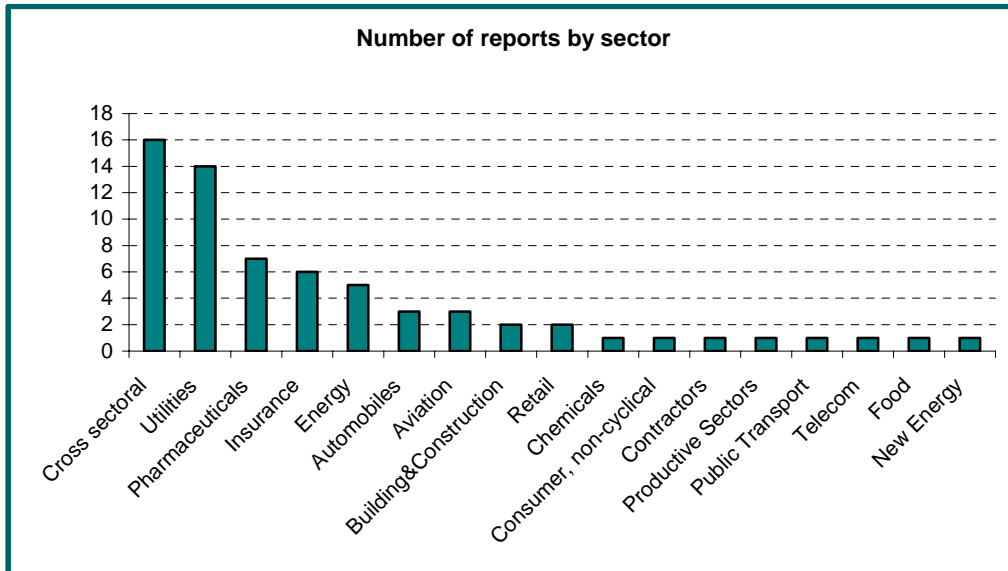
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We observe the following trends:

- Given its importance, corporate governance is not a highly researched topic. Only three of the top 10 brokers systematically cover this issue.
- The introduction of the European emissions trading scheme has led to a large number of research outputs, some of them with repetitive insights which may indicate the potential for the EFI-equivalent of “me too” coverage (as currently happens with financial statements). This would not be a welcome development.
- Given their importance for company value creation, it is surprising that issues such as intellectual capital management and human capital management (including remuneration systems and HR management) are comparatively under-researched.
- Changes in regulatory frameworks (including accounting, reporting, litigation trends) are an emerging topic of research by brokers.
- Brokers have been relatively quick in picking up on some emerging geo-political risk issues (e.g. terrorism), but the analysis is not very comprehensive yet.
- Extra-financial issues in the context of corporate restructurings/M&As have not been a topic of systematic research yet.
- Some issues which are particularly important in emerging countries and which can destroy company reputation and brand value, such as contractors and supply chain risks, or bribery and corruption, are practically missing from the radar-screen of brokers.
- Several brokers are focusing their EFI analysis on the sector or issue level, and have not yet developed frameworks to integrate this kind of research in company and stock analysis.
- Some brokers have started to experiment with methods such as structured stakeholder consultations or scenario based trend analysis to better capture impacts of EFIs.
- Some brokers have generated new insights by teaming up with strategic consultants, external experts or academics, or by forming internal teams of analysts from different sector teams.

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The focus on certain issues also leads to the fact that certain sectors are better researched than others, as can be seen from the next figure:



## 3. Outlook for 2005

The evaluation of brokers' commitment to produce relevant research in 2005 shows that several incremental improvements are planned, but no major "leaps". As many brokers are planning major investments in the field, EAI is confident, though, that the quality and coverage of EFI will improve considerably in the near future but acknowledges that this depends on additional clients sending a clear signal that this is what is wanted. In particular, the presence of a U.S. asset owner would have a significant impact on global brokers.

Selected highlights from the analysis of future commitments are:

- Brokers have indicated several new areas planned for their extra-financial research in 2005. Overall, though, the choice of issues and methodologies is not very innovative. EAI encourages brokers to research also new issues and develop innovative methodological approaches, thereby taking a lead in further developing the extra-financial research agenda.
- Some brokers have announced that they will provide global or European coverage of sectors and companies for certain EFIs, a development which EAI highly welcomes.
- Some brokers are investing in separate EFI teams to catalyse and coordinate efforts, others prefer to integrate EFI research in existing research operations. All brokers agree that EFI issues should be integrated as much as possible in analysts' everyday work.
- Some brokers still rely heavily on existing SRI teams and resources, while others see EFI research as a mainstream issue to be integrated in the mainstream research process.
- Only a few brokers have told EAI that they plan to develop truly new and innovative methodological approaches to integrate EFIs in company analysis.
- One broker is including the work of mainstream analysts in the area of extra-financials in their annual performance review, which EAI believes is an important step to motivate analysts working in this field.

## 4. Comparative evaluation of brokers

From the initial universe of 21 brokers which have responded to EAI's call, and based on the detailed evaluation undertaken, EAI has decided to commend the following seven highest ranked brokers, in terms of both their quality and coverage of past research output and of their commitments for 2005. In general, EAI members will allocate their 5% commission, for the first half-year of 2005 to these brokers. These are, in alphabetical order:

- Deutsche Bank
- DrKW
- Goldman Sachs
- HSBC
- Morgan Stanley
- UBS
- WestLB

According to our evaluation, these brokers have provided best quality EFI research since January 2003, have a stable to positive outlook for 2005 and have shown a considerable commitment to produce high-quality EFI research in 2005.

It should be noted that at each of the planned half-yearly ongoing evaluations, all brokers will be considered as eligible for being included in this top category. Performance of a previous evaluation will not determine whether a broker is included or not in future evaluations.

In addition to the seven brokers mentioned above, we would like to highlight the next three ranked brokers, which also scored high in terms of quality and coverage of past research output and of future commitments (in alphabetical order):

- ABN AMRO
- Citigroup
- CM CIC

In terms of their commitment to the EAI initiative and to delivering interesting EFI research in the coming year, we would also like to mention (in alphabetical order):

Bear Stearns, BNY Jaywalk, Exane BNP Paribas, ING, JPMorgan, Sanford Bernstein.

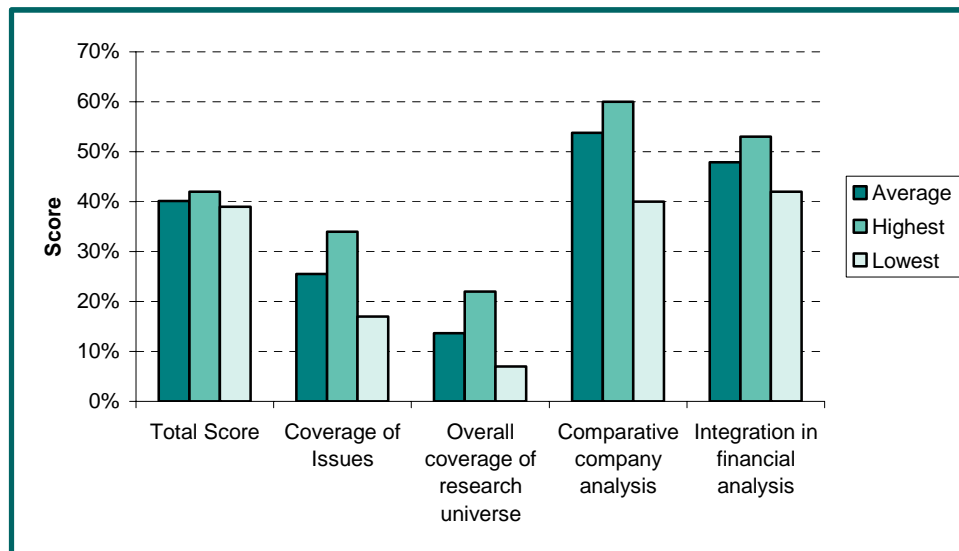
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## Detailed results

If we look at the scores for past research output of the seven top-ranked brokers for the first half-year of 2005 (next figure), we notice that the total scores are all very close to the average total score of 40% (on a scale between 0%-worst and 100%-best). The competition within the group is therefore high.

Looking at single key criteria defined by the EAI initiative, the spread between the best and lowest ranked institutions is larger. The differences between brokers are particularly high with regard to the coverage of relevant EFI issues (max. score 34%, min. score 17%) and to the overall coverage of the research universe (sectors and companies – max. score 22%, min. score 7%). The average scores for coverage are still relatively low, given the fact that most brokers are covering only few sectors and issues, or provide global sector coverage but poor issue coverage.

Scores for the quality of comparative company analysis and integration in financial analysis are higher, in the range between 40% and 60%. The still relatively low score levels show that our evaluation system is challenging but has at the same time the advantage that it can be used to monitor and track progress in the coming years. For example, we expect to see rapidly increasing values for the coverage indicators as brokers are planning to increase coverage over the coming years.



## 5. Selected examples of particularly interesting and innovative research

Almost all brokers surveyed have provided interesting examples of research. Some of them have contributed particularly innovative approaches. We would like to highlight a selection of reports that we found particularly interesting and innovative (not a complete list):

### ***ABN AMRO: Research Process - Climate change and analysis***

ABN AMRO's report stands out for its clear structure, highly supportive graphs and good overall comprehensiveness. The 32-pages-report is easy to read and finds the right balance between detailed insights and straightforwardness. A basic analysis of opportunities and risks, physical and regulatory environmental impacts across all sectors has been conducted based on a joint effort of analysts from different sector teams. A simple model to integrate the findings in equity valuations is proposed.

### ***Deutsche Bank: Beyond the Numbers Series***

In their "Beyond the numbers" series, DB provides a comprehensive snapshot of current Corporate Governance practices, executive remuneration and value creation for S&P 500, FTSE 350 and major oil and gas companies. In addition, they provide key financial ratios and trends to enable readers to establish links between Corporate Governance practices, remuneration and financial value creation. Deutsche Bank builds its analysis on data providers such as IRRC, ISS's and CGQ. The Oil&Gas report also provides sector specific Corporate Governance insights.

### ***Dresdner Kleinwort Wasserstein DrKW: Emission trading – Carbon Derby Series***

DrKW released its first report on the impacts of the European emission trading system in February 2003 – almost two years before the planned implementation of the framework. Regular updates have tracked the increasing knowledge on timelines, terms and conditions over the past months. It is also one of the few report series that systematically discusses uncertainties. Carbon constraints across European countries have been modelled for two periods: 2005 to 2007 and 2008 to 2012 using different scenarios. DrKW has fully integrated their findings into individual equity valuations across European utilities. This work has also lead to spin-off reports covering the Transport and Building & Construction sectors.

## ***HSBC: How much for a tonne of CO2***

HSBC's research on the topic of carbon pricing stands out because it is one of the few that provides a comprehensive overview of 3<sup>rd</sup> party research on the topic. It provides a comprehensive analytical framework and an overview of research sources on the topic.

## ***Goldman Sachs: Global Energy – Introducing the Goldman Sachs Energy Environmental and Social Index***

This report stands out for its comprehensive and strategic analysis of relevant environmental and social issues for major oil and gas companies. GS uses a straightforward methodology to qualitatively and quantitatively analyse issues relevant for different stakeholders and checks their strategic relevance for corporates and investors by using several in depth case-studies. A criteria-based process is used to score and rank companies according to different criteria. GS is one of the few brokers who undertook the effort to systematically assess the impact of a comprehensive set of EFIs on individual companies. In addition, this report is a rare example of a systematic analysis of the impact of EFIs over different time-horizons.

## ***UBS Investment Research: European Emission Trading System – Bonanza or bust?***

In their research on the impact of the European CO2-emission trading scheme on the valuation of European utilities, UBS joined forces with strategy consultancy McKinsey. Using a simple scenario approach each analyst was asked to contribute to the description of different scenarios, including a disaster, black sky, central and blue sky scenario. Each analyst was also asked to indicate his or her country sensitivities. This resulted in estimates of 'value at risk' as well as in rough indications for the expected impact on company value.

## ***Bernstein Research: The Long View***

## ***Morgan Stanley: The Competitive Edge***

## ***UBS Investment Research: Q-Series: Forces Colliding?***

Bernstein, Morgan Stanley and UBS stand out because of their well-established research series focusing on long-term trends impacting sectors, industries and companies.

UBS's Q-Series is highly innovative in its approach. The series addresses underlying industry and sector trends and proposes ways for integrating them in analytical frameworks for the buy side. At the same time the reports are also a tool to educate the "normal sell-side" analyst within UBS. In their consumer products study "Forces Colliding?" UBS joined forces with a strategic brand-development

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consultancy to undertake an extensive team-wide scenario analysis to capture the long term strategic success factors of consumer brand companies.

Morgan Stanley's "Competitive Edge"- and Bernstein's "The Long View"-series are potentially excellent frameworks for the analysis of extra-financial issues across sectors. The Competitive Edge's focus, however, limits itself to well-established aspects such as scale, brand, financial strength or cost control and rarely expands its focus to emerging issues and trends which could impact value creation of sectors and companies. The Long View series is highly issue oriented. While providing interesting and well researched insights on single extra-financial issues within an industry, it hasn't so far provided a comprehensive coverage of extra-financial issues.

We would also like to mention the following reports for their interesting contributions to a better understanding of EFI material impacts on sectors and companies:

- Citigroup: Global Environment and SRI
- CM CIC: Corporate Governance and Transparency
- WestLB: Carbonomics.