

### *The Equity Research Industry*

#### *Company Focus: Wall Street Strategies*

#### Overview

November 3, 1999 -- The landscape for the financial information business has changed remarkably in just the past few years. The increase in the number of self-directed investors has created demand for unbiased and independent stock market research that provides trading ideas. Wall Street Strategies, Inc. is in an excellent position to capitalize on the tremendous growth in subscription and advertising revenue in this market which appears to be far from saturated.

#### The Democratization Of Wall Street

The financial information industry is going through a period of tremendous change that has led to the emergence of a new consumer of financial information. The participation of Americans in the stock market has greatly increased. Since 1982, the S&P 500 has risen at an average annual rate of 19.2%, well above its long term average of around 11.0%. Since 1994, the S&P 500 has done even better with a stunning return of 24.9% annually. It is now widely accepted wisdom that the stock market is the only place for individuals to invest their money to maximize long-term gains.

These substantial returns have led to a nearly unprecedented level of participation in the stock market among Americans. The current share of household assets held in equities is currently near the peak of 34.4% posted in 1968. US equity mutual funds now total over \$3 trillion and are held by about 77.3 million Americans, according to the Investment Company Institute.

It used to be that private investors participated in the stock market primarily through mutual funds. But despite a nearly 600% increase in assets held by the mutual fund industry in the past decade, investors are getting away from mutual funds in favor of making their own investment decisions. This is

evident in the pace of mutual fund inflows which have been declining since peaking early in 1996. Most of the recent gains in mutual fund assets have come from share price appreciation. The new money flowing into the stock market is likely coming from individuals' stock trading accounts, not from mutual funds.

The Internet has ushered in the era of the online broker which permits investors to make equity trades at discount commissions. It is generally agreed that one out of every five to six trades is now made through an online broker. Between the end of 1998 and August of 1999, online brokerage account assets rose 45% to \$608 billion according to the *Wall Street Journal*. There were an estimated 2.4 million online investors at the start of 1999 with another 1.9 million expected to open accounts by the end of 2000. Data from Forrester Research estimates that 9.7 million US investors will have \$3 trillion in self-directed online accounts by the year 2003. Clearly, this is an exploding target market.

Part of this increase in online accounts is due to the lagging returns of actively managed mutual funds in relation to the S&P 500 stock index. Early in the 1990's, 60% of the actively managed mutual funds beat the S&P 500 index. However, that figure then fell steadily and by 1997, for example, only 10% beat the index.

Investors pay heavily for that underperformance, shelling out an average 1.44 percentage points in expense fees for the actively managed fund, over three times what the average index fund charges. With overall share prices rising sharply since 1994 and with Internet stocks showing astounding rates of appreciation, many investors have come to the conclusion that they can do just as well at managing their money as the professionals, and for a whole lot less. The online brokerage industry has made this possible.

The Internet and the efficiencies that it represents have driven a wedge between individuals and traditional brokerage firms. The low commission structure of these brokers (trades can be made for as little as \$5) has persuaded individual investors to give up their full-service brokers and go to the online brokers. Since discount brokers typically don't produce their own research, this leaves an opening to be filled by the independent research companies.

## The Changing Financial Information Industry

Previously, demand in the financial research business was met by high-end financial information giants (Reuters, Dow Jones and Bloomberg) and by the Wall Street brokerage firms which produced research in house. Now, demand has risen for timely and provocative research products tailored directly for the individual investor.

While the Internet has fed the growth of the discount broker, it has also made it possible for financial information to be distributed to tens of thousands of users for relatively low fixed costs and nearly-zero marginal costs. In just four years, the number of households with PC's has tripled to 38.8% according to Forrester Research and AOL now has 20 million subscribers. Dow Jones & Company, the publisher of the *Wall Street Journal* (the most widely read US paper with 1.8 million subscribers), has fewer subscribers but an enormous fixed investment in infrastructure like printing presses, distribution networks and satellites.

The Internet has sharply reduced the barriers to entry into the financial information business and allowed small, nimble firms to publish and distribute research. Technological advances have made it possible for small firms to compete on a nearly equal basis with the larger, more established firms.

Financial market data is widely available across many platforms (TV, radio, magazines, newspapers, Internet, etc.) and content is spread among many different price points ranging from free to thousands of dollars per month. The downside for those seeking to sell market data has been a dramatic compression in the prices at which research can be sold. A tremendous amount of information can be found for free on the Internet as established firms offer content to attract Web site visitors.

Merrill Lynch & Company for example, which had previously sworn off the Internet, has now entered the fray. The world's largest brokerage firm is set to challenge the world's largest e-broker Charles Schwab (25% of the market) with the launch of online trading in December. Morgan Stanley Dean Witter in October announced its intention to start an online brokerage immediately, an attempt to head off Merrill Lynch. The traditional brokerage firms are no doubt envious of Schwab's success in attracting new customer funds. Schwab has attracted about \$25 billion in new equity every quarter for +40% year-on-year growth. E\*Trade signed up 310,000 new accounts alone in its fiscal Q4 ended in September.

American Express also recently announced plans to launch an e-brokerage business. American Express will be combining online brokerage services with advice from its network of financial planners. American Express also plans to

offer free trading to customers with over \$100,000 in account balances and will not charge customers with \$25,000 or more to buy stocks. The interesting factor here is the offer of free trading. Commissions are moving lower and it is getting tougher for online brokers to make money from commissions.

Online trading is fast becoming a commodity service with a price war currently being waged. Execution services and research, once the domain of the traditional brokerage firms, are coming unbundled. If price becomes less of a consideration in choosing an online broker, then the value of additional services offered will increase as brokers pursue market share. Up-to-date and interesting financial research offers an opportunity for online brokers to differentiate themselves from each other and build their market share.

## A Niche Exists

While much financial information is available for free on the Internet, there does appear to be a niche for companies that can provide independent financial research with an edge. Many investors cast a jaundiced eye at the research of the brokerage firms, placing a value on independent research companies. Often, analysts' opinions are formed not so much from objective analysis as from the firm's relationship with the companies that are being analyzed. An analyst will be reluctant to issue negative comments on a stock, for example, where the investment banking side is pursuing fee income from a stock or bond issue.

It is also possible to successfully charge a subscription fee and attract advertisers with financial information that provides actionable advice, i.e., trading recommendations. There is little shortage of information available on the Internet, but investors have shown a willingness to pay for trading advice. A niche also exists for the financial Web site associated with a personality such as Jim Cramer of *TheStreet.com* or the *Motley Fool's* David and Tom Gardner. Their voices and high profiles have been instrumental in building brand awareness at a relatively low cost.

## The Industry's Marketing Practices

Online research providers have been using several methods to keep their heads above the din of the modern financial press. The most effective is the practice of linking up with the online brokers of which there are approximately 130. Linking up with an e-broker places the research, possibly at a discount, in front of the most focused group of consumers that the online research company could ask for. These link-ups are crucial.

Ameritrade customers, for example, get free market data from *Briefing.com*, *Zacks Investment Research*, *CBS Market-*

Watch.com, the Motley Fool and Morningstar.net. They also have the option of subscribing to "premium" data from the TheStreet.com, Standard & Poor's and MarketEdge, sometimes at a discount. CBS MarketWatch.com signed a content deal with Fidelity to deliver both its financial research and tools from BigCharts which it owns.

In some respects, the online brokers are doing the advertising and building brand recognition for their affiliated online research providers. Over the next year, the top 10 online brokers have budgeted \$1.5 billion for ads that will blanket, TV, radio, magazines, and newspapers. Ameritrade is tripling its ad spending in the year 2000 in order to compete. The affiliated online research firms will benefit from this massive advertising drive without having to pay upfront advertising costs.

Research providers are also trying to position themselves on the web portals. AOL has an agreement with CBS MarketWatch.com which paid \$21 million for the exposure. The firms plan to split revenues.

Online research firms are trying to make inroads on the more established financial news companies. In the summer of 1999, TheStreet.com launched a broadside at the established financial research houses when its Professional Markets Group (PMG) reached an agreement to provide "premium" service to Mesirow Financial's European clients. TheStreet.com's PMG has reached similar deals with fifteen other institutional firms. The company is aggressively trying to offer its services to institutional investors and recently hired two veteran financial news editors to beef up its derivatives research and make it available on a more real-time basis. The deal is also an indication of plans to expand abroad and the company has opened a London office.

TheStreet.com is also partnering in less conventional ways. In August, the company announced a pact with First USA, the largest VISA card issuer, that gives the credit card company exclusive rights to market its services while TheStreet.com receives access to First USA's cardholder base.

## How Online Research Firms Earn Revenue

The current business model for deriving revenue from selling financial research on the Internet entails both subscription fees and advertising revenue.

TheStreet.com has a public, albeit short, operating history, and it may be instructive to look at its results. Subscription growth for TheStreet.com has been very strong. In 1998, the company experienced a 378% increase in subscribers to 32,000. At the end of Q2-1999, the company had 60,000

subscribers, an 87.5% increase from the end of 1998. Correspondingly, subscription revenue rose to \$934,000 in the second quarter, a 108% quarter-on-quarter gain. TheStreet.com has also been successful in retaining its customers, enjoying an 81% renewal rate for annual subscriptions and a 97% rate for monthly subscribers according to company filings.

The majority of TheStreet.com's revenues, however, come from advertising (banner ads, e-mail promotions), and those revenues have shown even stronger growth. TheStreet.com had Q2-1999 advertising revenue of \$1.74 million, a nearly 200% quarter-on-quarter gain. The outlook for continued advertising revenue looks favorable. Forrester Research estimates that overall online advertising spending in the US will grow to \$22 billion by 2004 from \$2.8 billion now, representing a 50% compounded annual growth rate.

Financial Web sites are an attractive advertising venue due in part to the favorable demographics of their users. Forrester Research pegs the net worth of the average online investor at \$236,000, an appealing target audience. Plus, subscribers to online services have already demonstrated a willingness to make purchases over the Internet.

Moreover, financial Web sites are a popular destination. CBS MarketWatch.com reported that in Q2 it had a monthly average of 3.8 million unique visitors to its website, a 217% year-on-year increase. As long as the web-sites can secure visitors, advertising revenue should stand up.

## Wall Street Strategies, Inc.

Wall Street Strategies was founded in 1990 and has become a leader in the field of independent financial market research. The company has 8,000 historical subscribers and 4,000 active subscribers representing over 250 brokerage firms in North America and the UK, according to company officials. Wall Street Strategies' competitive edge lies in its ability to provide effective, timely and independent stock market advice which identifies buying and selling opportunities in the market. Wall Street Strategies has positioned itself as a source for trading ideas outside of the brokerage firms' research (which can be biased) and the noise of Internet chat rooms.

The philosophy and methodology behind the company's recommendations lies in this belief: stocks traditionally become "hot" over a period of time. In the early stages of a stock's move, it is not uncommon for insiders to accumulate positions, followed by money managers and traders. After the stock has made a substantial move and gains momentum, major brokerage firms will make official buy recommendations to their clients. At this point the stock is considered "hot" and insiders, money managers and traders have already

realized gains. The price of a stock usually peaks when it becomes the subject of mainstream news reports and magazine articles. Wall Street Strategies believes that its proprietary formula enables its clients to accumulate positions at the same time that insiders and professionals are accumulating and just as importantly, receive exit advice on when to take advantage of favorable price and volume.

Charles Payne, CEO, principal analyst and director of Wall Street Strategies, is the head market technician and editor of all product content. Mr. Payne is the "personality" behind Wall Street Strategies much as Jim Cramer is behind the TheStreet.com. This personality factor is important for building brand awareness. Mr. Payne appears bi-weekly on CNNfn and is a regular guest on Canadian television, CTV's NEWSNET. Mr. Payne is also quoted regularly in *The Wall Street Journal*, Bloomberg and *Worth Magazine* as well as on TheStreet.com and CBS MarketWatch.com. The company recently structured a revenue sharing deal with Data Broadcasting Corporation which will feature Charles Payne as the keynote speaker in a series of seminars.

Wall Street Strategies has a range of products that span different price points and trading horizons. *First Alert* is a research service for the active trader updated four times daily with a monthly subscription fee of \$300. The *Hotline* is a product developed for longer-term investors and is updated twice daily, usually with one story stock. A subscription to the *Hotline* is \$250 per month. Wall Street Strategies' *Newsletter* is published monthly and subscribers receive weekly updates. The investment time frame for the *Newsletter* is longer and the subscription price is lower at \$50 per month. *Storyline* is a \$300 per month product that takes advantage of the company's extensive network of market professionals in assessing and reporting rumors and M&A speculation. For the professional market, Wall Street Strategies has its premium *Institutional Service* which has a quarterly subscription rate of \$5,500.

The company is currently in the process of developing its Internet presence in partnership with experienced online marketers. The company's move to the Internet will allow it to lower costs and improve its distribution model due to vastly cheaper electronic delivery costs. The company is also attracting managerial talent from established research firms like Morningstar and Zacks.

Still, Wall Street Strategies, like other online research firms, faces some significant risks. A sustained bear market in the US equity market, for example, would no doubt cool investors' appetite for financial data. While the company is forecasting a profit in the year 2000, many of its competitors are still operating at a loss and are projecting losses into the foreseeable future. Wall Street Strategies also faces significant competition in a crowded market from larger online re-

search firms.

## Valuation

The stock market is currently placing a high multiple on the sales of the online research firms. At TheStreet.com's current market cap of nearly a half a billion dollars, the market is valuing each subscriber at over \$8,000 (using Q2 subscriber figures). TheStreet.com trades at 61.2 times 12-month trailing sales while CBS MarketWatch.com trades at 62.6 times sales. The market has applied lower valuations to companies that provide research which is more analytical in nature. Multex (MLTX) and Hoovers (HOOV) trade at 8 and 3.5 times sales, respectively. Still, TheStreet.com and CBS MarketWatch.com trade at lower multiples than benchmark Internet companies like Yahoo! (101.7) and eToys (82.5).

In 1997, Wall Street Strategies had revenues of \$1.46 million dollars according to data released by the company. Revenues rose to \$2.46 million in 1998, a 68.5% y/y advance and the company estimates that 1999 revenues will total \$4.2 million, a 71% y/y advance. Applying the average price to sales multiplier (61.9) of TheStreet.com and CBS MarketWatch.com to Wall Street Strategies' revenue would give the company a market capitalization of about \$260 million, assuming similar revenue growth rates. That is the equivalent of \$14-3/4 per share, well above its most recent close of \$4. The company is currently trading at 16.7 times 1999's estimated revenue.

Wall Street analysts currently rate Wall Street Strategies' peers very highly. Six Wall Street analysts are currently following the TheStreet.com and CBS MarketWatch.com and all have buy ratings on both companies. Stock analysts don't expect either company to show a profit this year or next, however, a common side effect of the Internet business model.

## Conclusion

The advent of the discount online brokerage industry and the rise of the self-directed investor has created a strong opportunity for companies that can provide stock recommendations. Wall Street Strategies is well-positioned to take advantage of this exploding marketplace. The firm has been experiencing strong subscriber growth and Charles Payne has been very effective in placing his research in front of a large audience. Wall Street Strategies has strong growth potential and appears to represent an attractive investment opportunity.

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