Equity Research – A practical perspective

Stamatis Draziotis, CFA

Firstly, an introduction…

Stamatis Draziotis, CFA
General Manager, Head of Equity Research,
Eurobank Equities Investment Firm

Institutional Investor

1st Analyst for Greece Equity Research

SURVEYS 2012, 2013, 2014, 2015, 2016, 2018, 2019, 2020, 2022

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- Expert in the broad consumer sector:
  - Retail, Consumer, Beverages, Gaming, Airlines, HPC and Telecoms at Eurobank Equities
  - Previously covered Global Tobacco, Hotels & Leisure at UBS Investment Bank in London
- 16 years of multi-sector experience as equity analyst
- **CFA Instructor:** teaching equity valuation to CFA students – since 2017
- **ATHEX ROOTS program:** acted as a mentor to small and medium-sized enterprises by offering capacity-building workshops to participating companies wishing to get access to capital markets.

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Equity research: more art than science…?

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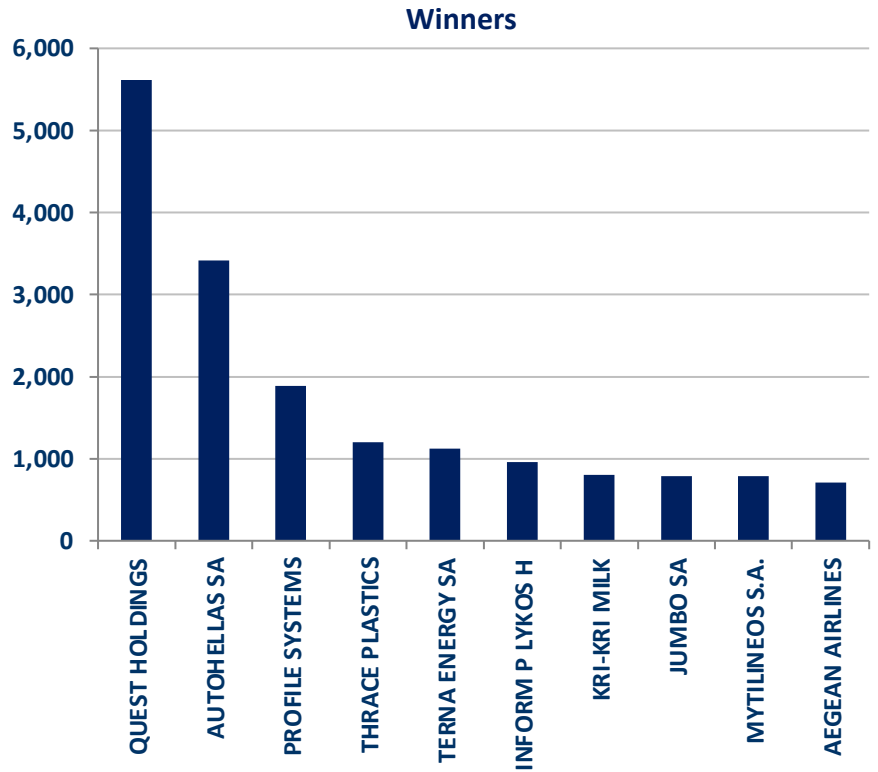
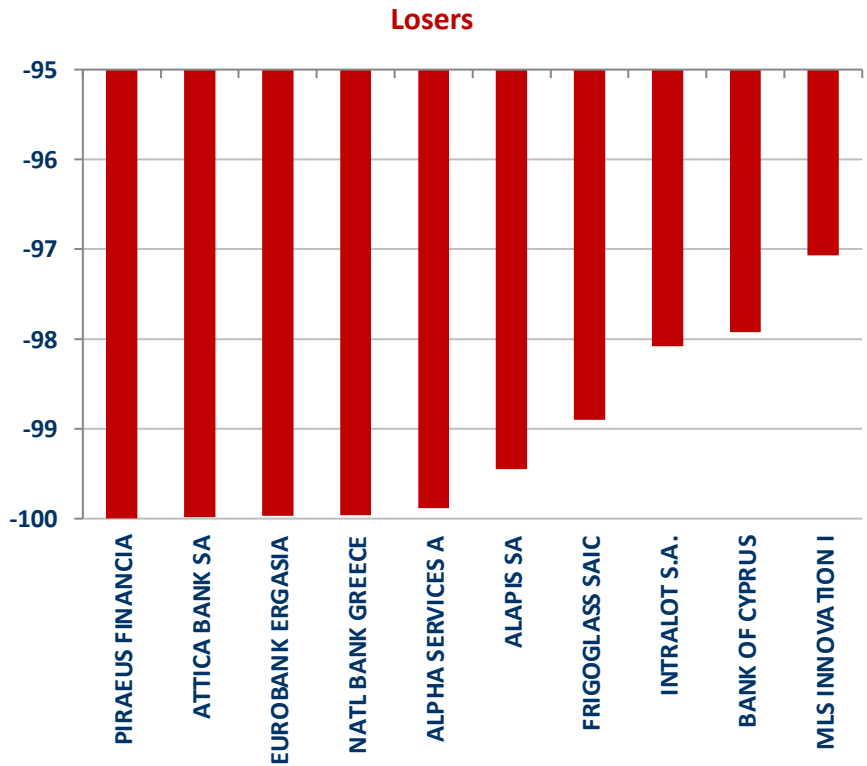
Fundamentals matter…

ASE index member returns (in %) since 2010 - Winners



Source: Bloomberg

ASE index member returns (in %) since 2010 - losers



Source: Bloomberg

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Why is equity research useful...?

Much more than producing a report and coming up with a valuation…!

Vital role in capital markets:

1) Price formation

- ✓Establish market context, e.g. consensus for earnings
- ✓Establish valuation context, both absolute and relative
- ✓Contribute to the market efficiency by disseminating information and managing investor expectations

Events and announcements would be a surprise otherwise, increasing equity volatility!!!

2) New issuance and access to capital

- Open and "researched" markets usually have higher levels of valuation (and liquidity) → lower cost of capital, easier access of firms to capital
  - E.g. think of firms in emerging markets wishing to list in London instead of their home market
- Equity research provides insight into the long-term potential of companies which may be currently loss-making → balance risk vs. reward
- Promotes growth of the economy by reducing dependence on bank financing

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The role of the analyst

- Provide information and sector/market insight
- Stimulate ideas
- Stock picking and safeguarding alpha for buy side investors
- Communication with clients
- Marketing of ideas

"We are not buying recommendations, i.e. buy/sell Vodafone, and then measuring whether it was a good or bad decision. It's the process behind that."

"Some want a clear investment conclusion, whereas others say 'that's my job'."

Fund managers often deny paying attention to buy and sell recommendations…

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The day-to-day

Company meetings

Dealing with news flow

External client communication (ad-hoc requests, proactive calls/emails)

Writing

Roadshows

Reading

Modelling, numerical exercises

Internal client communication (e.g. sales)

Research

→ **news flow is not research!**

No day is the same as the others…

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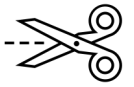
The attributes

Key attributes for success

- **Self-motivation:** take initiatives, come up with new ideas, think out-of-the-box and, ultimately, help clients generate alpha
- **Focus:** given the multiple distractions and flow of data that an analyst is faced with every day, staying organized and focused on the information that matters is a key trait for success

Other important skills

- **Skepticism:** Good analysts rarely accept anything at face value. Never fully trust management teams
- **Keeping it simple:** Simple models, well-presented thesis and easy-to-understand messages in research reports



Soft skills

- **Communication:** distill information into a clear and understandable message, convey complex messages during client roadshows
- **Confidence:** but don't overdo it…
- **Empathy:** be aware of the clients' perspective so that you can better cater to their needs and get the most out of the business relationship

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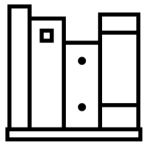
So what about the most obvious traits?

- **Excel and modelling:** Obviously important, but you don't need to be an expert. Just understand basic concepts and avoid mistakes
  - Assumptions vs. outputs
  - Formulas vs. inputs
  - Cross checking

- **Valuation skills:** Again basic concepts are required. Key is to identify the right valuation methodology and come up with assumptions that make sense!!!

- **Accounting skills:** Financial statement analysis concepts are necessary, as are relevant concepts (cash conversion cycles, return on capital etc.).
  - Most important is to be able to identify (or suspect) accounting shenanigans.

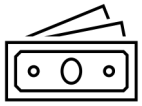


- **Writing skills:** Research reports are not PhD theses…
  - Need to be punchy
  - Have specific message → aimed to help the investor make an informed decision and take action on a stock

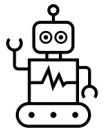
The challenges

- **Generate ideas**
  - ✓ Effectively help clients generate alpha

- **Differentiate and stand-out**
  - ✓ E.g. anti-consensus calls
  - ✓ Transformation of products (e.g. many published research reports opining on same stocks and market developments)
  - ✓ Provision of scarce, time-sensitive, and customized services



- **Unbundling of fees (MIFID II) and other regulatory disruptions**
  - ✓ Spending on research declining
  - ✓ Limitation on the number of research providers used by asset managers
  - ✓ Need reinvention of equity research as a profit-making center (e.g. issuer sponsored research?)



- **Adopting new technologies to generate novel investment ideas and lower costs**
  - ✓ E.g. Leverage AI to interpret high-frequency market data in real time, patterns in supply and demand chains, data in social media.

- **Shift from active management to quantitative and passive strategies**
  - ✓ Role of analysts less relevant

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Practical challenges – Analysts vs companies

WACC

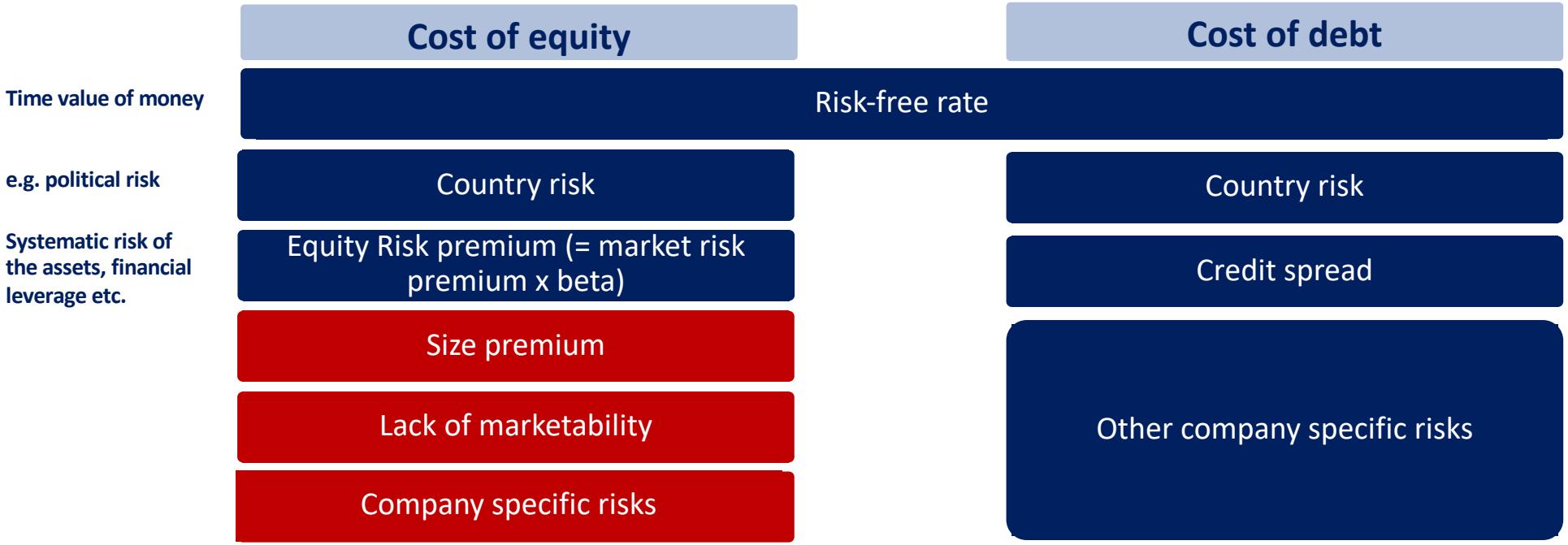
Firm size, stock illiquidity

Stock rating nature

Good company = Buy rating

WACC

- **WACC in general**
  - A firm's average after-tax cost of capital from all sources, including common stock, preferred stock, bonds, and other forms of debt.
  - WACC is the average rate that a company expects to pay to finance its assets.
- **WACC from a sell-side equity research perspective**
  - The return that both bondholders and shareholders demand to provide the company with capital.
  - Used as the discount rate for future cash flows in discounted cash flow analysis



$$\text{WACC} = \left(\frac{E}{V} \times Re\right) + \left(\frac{D}{V} \times Rd \times (1 - Tc)\right) \Rightarrow WACC = f(x_1, x_2, x_3, \ldots, judgment)$$

WACC | Size premium

- **We normally tend to extend the basic CAPM formula with the size premium**
  - Historically, investments in smaller capitalization common stocks have achieved a higher investment return than large cap stocks, partly due to the higher level of risk associated with smaller companies.

Cost of equity = Rf + β × MRP + SP

Examples of size risks

- ✓ Less flexible access to capital market and financing
- ✓ Lower liquidity
- ✓ Lower transparency in reporting
- ✓ Dependence on key management (e.g. key person risk)

✓ **One needs to be mindful of avoiding the double-counting of risks (e.g. cash flows or discount rate)**

WACC | Betas

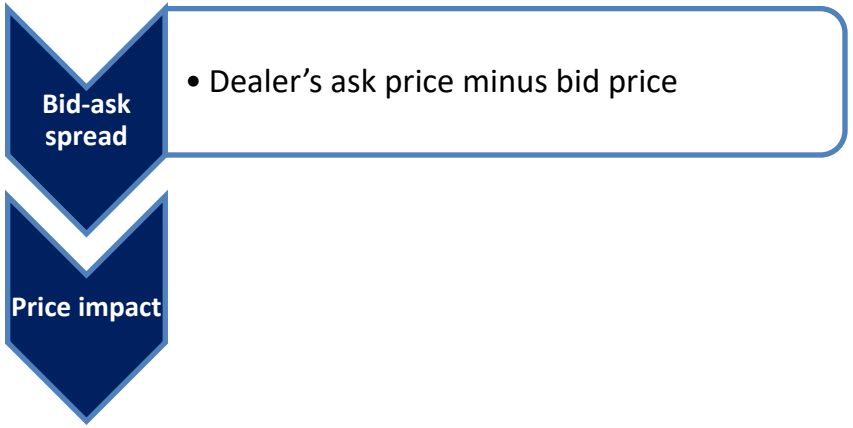
- The **beta** is a correlation measure of equity returns with market returns.
- It represents the **systematic risk of a security** or a portfolio in comparison to the market as a whole.
  - Depending on the time horizon and periodicity of beta estimation, the beta might vary significantly.

- **Smaller caps or less liquid stocks tend to have ultra low betas**
  - We opt for the **Blume adjustment** to reflect the tendency of betas to revert to 1
    - Improves the estimate of a beta that seeks to reflect future risk
    - $Adjusted\ beta = 2 / 3 * unadjusted\ beta\ raw + 1 / 3 * 1$
  - Alternatively **we use an industry beta** rather than the beta of an individual company
    - The economic rationale is that business risk, or variability of cash flows, will be similar for all companies within an industry.
    - We **then re-lever** the beta for the specific company

- These **adjustments produce higher betas** and, as a result, **higher cost of equity** than companies themselves have in mind by applying a “plain vanilla” CAPM framework

WACC | Illiquidity

- Effectively the cost of reversing an asset trade immediately after the trade is made.

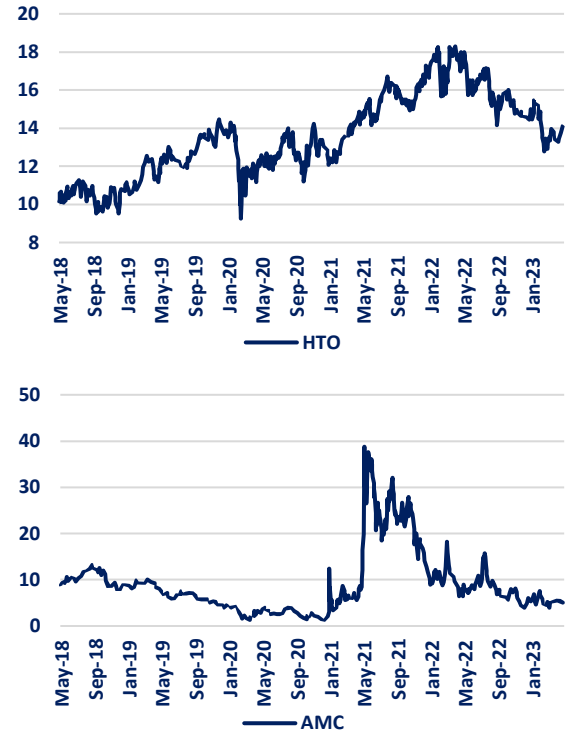


- **Illiquid assets should be valued using higher discount rates**
  - From a practical viewpoint, when an investor pays for a asset today, she may incorporate the present value of all expected future transaction costs on the asset (Amihud and Mendelson).

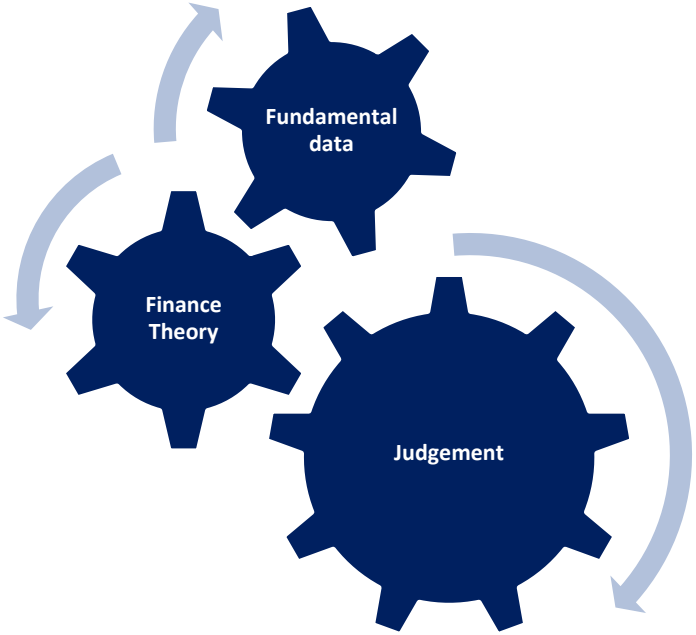
Stock rating nature | Good company vs good investment

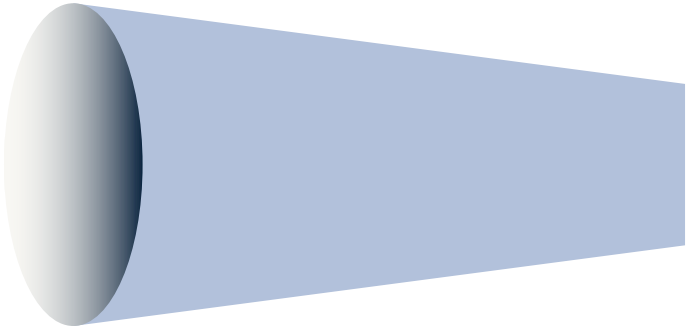
- A company's stock trading on an exchange is influenced both by fundamentals (good company) and technicals (e.g. trading flow, demand vs supply)
- Stocks can trade at unreasonable prices for long periods of time
  - Emotions
  - Momentum
  - Innovation
  - Demand (e.g. stock drawing attention of analysts or being ignored by analysts)
- In the long run, stock prices and intrinsic values ought to align

- A good company can be a Sell
- A bad company can be a Buy temporarily

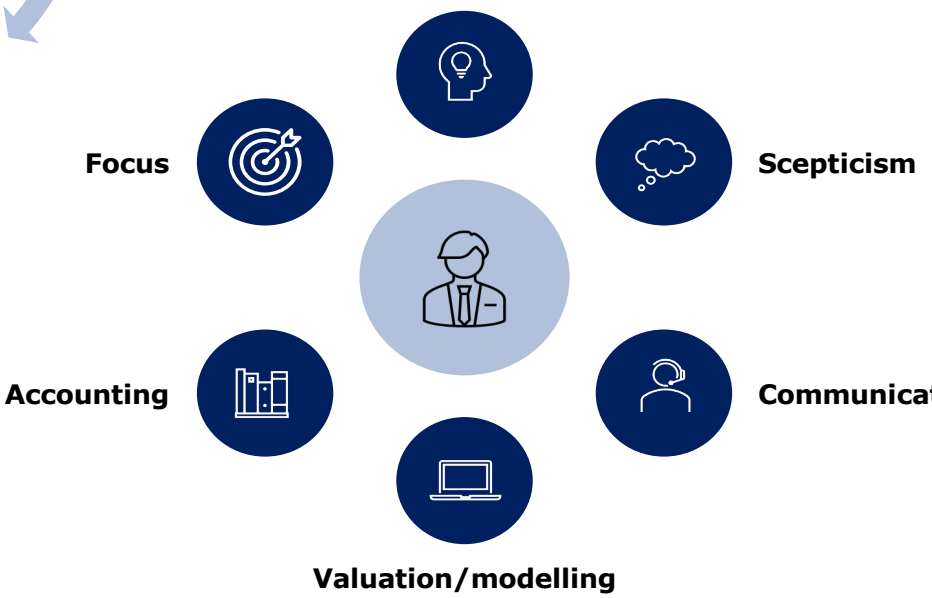


Summing up…


Fundamental data
Finance Theory
Judgement




Eurobank
COMPANY UPDATE
FOURLIS
Waiting is the hardest part


Self motivation
Focus
Scepticism
Accounting
Communication
Valuation/modelling

Thank you!!

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General Manager - Head of Research

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